IN THE

Supreme Court of the United States

OCTOBER TERM, 1973

No. 73-1113

FEHRS FINANCE COMPANY,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

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To the Honorable, the Chief Justice and Associate Justices of the Supreme Court of the United States:

Fehrs Finance Company, petitioner herein ("Finance"), respectfully prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Eighth Circuit, entered in the above case on November 6, 1973.

OPINIONS BELOW

The opinion of the Tax Court of the United States is reported at 58 T.C. 174 (1972). The opinion of the Court of Appeals for the Eighth Circuit is reported in 73-2 U.S.T.C. ¶ 9767. Both opinions are printed in the Appendix hereto.

JURISDICTIONAL GROUNDS

The decision of the Court of Appeals was entered on November 6, 1973. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(a)(1).

QUESTIONS PRESENTED FOR REVIEW

The sole question to be decided in this case, in the courts below, was the proper basis for determining gain to be accorded certain shares of Fehrs Rental Company ("Rental") in the hands of Finance, such shares having been sold by Finance in the taxable year in question. These shares had been acquired from Mr. and Mrs. Fehrs in exchange for private annuity contracts. The acquisition of such shares constituted a redemption through the use of a related corporation, within the meaning of section 304 of the Internal Revenue Code. [The applicability of section 304 was contested by Finance in the Tax Court, but was not disputed on appeal.] Determination of the basis of the Rental shares in Finance's hands, under section 304, requires reference to several additional sections of the Internal Revenue Code. These sections, and the questions which are presented under them, are well stated in the opinion of the Court of Appeals:

> According to section 304 the acquiring corporation (Finance) must treat the stock acquired as a contribution to its capital.
>
> When the stock in question has been treated as a contribution to capital, the basis of that stock in the hands of the transferee (Finance) is the same as it would be in the hands of the transferor (the Fehrs), increased by the amount of gain recognized to the transferor on the transfer.
>
> It becomes necessary due to the interworkings of sections 304 and 362 of the Internal Revenue Code to

determine whether or not the Fehrs realized any gain on the redemption. If they did not, the basis of the Rental stock in the hands of Finance would be zero; i.e., the substituted basis of Mr. and Mrs. Fehrs. If they realized a gain, the basis of the Rental stock to Finance would be increased by the amount of that gain. Hence, Finance's gain on resale would be less.

Only gain realized by the Fehrs on a sale or exchange (capital gain) will allow Finance to receive the "stepped-up" basis for which it argues. If the transaction gave rise to dividend or ordinary income to the Fehrs, it would not affect Finance's basis.

Finance advances two theories, either of which it says will support the assertion that the transaction was an exchange giving rise to capital gain to the Fehrs, and therefore increasing Finance's basis in the stock. The two theories are found in 26 U.S.C. § 302(b)(1) and (3) and will be discussed separately.[1]

The Court of Appeals held that the redemption of the Rental stock from the Fehrs by Finance did not constitute an exchange under either section 302(b)(1) or (3). It disagreed with Finance's contention that the redemption was "not essentially equivalent to a dividend" within the meaning of section 302(b)(1) solely because it felt the percentage reduction of the Fehrs' interest to be too small. No other factors were considered by the Court, which interpreted this Court's decision in *United States* v. *Davis*, 397 U.S. 301 (1970), as holding:

> Determination as to whether or not the redemption had a "business purpose" is no longer a relevant inquiry regarding dividend equivalency under 302(b)(1).

In holding business purpose irrelevant, the Court overlooked the fact that this Court characterized "the fundamental test

[1] Under section 302(a), a redemption is treated as an exchange if it is "not essentially equivalent to a dividend" [§ 302(b)(1)] or if it is "in complete redemption of all of the stock of the corporation owned by the shareholder" [§ 302(b)(3)].

of dividend equivalency" as a distribution which is "pro rata or proportionate" to the distributee's stock interest and that it was in such a case that business purpose was disregarded. [397 U.S. at 306] Similarly, the Court disregarded the only explicit holding of *Davis:*

> After application of the stock ownership attribution rules, this case viewed most simply involves a sole stockholder who causes part of his shares to be redeemed by the corporation. We conclude that *such a redemption* is always "essentially equivalent to a dividend" within the meaning of that phrase in § 302 (b)(1) * * *. [397 U.S. at 307; emphasis supplied]

In the instant case, the distribution was **not** pro rata; the Fehrs' interest was reduced from 98.2%—of which 83.9% was held **directly**—to a wholly **indirect** interest of 88.7%. In cases not involving pro rata redemptions, additional factors, such as change from a direct to an indirect interest, loss of actual control, and business purpose, may be considered and may demonstrate that the distribution is **not** "essentially equivalent to a dividend." The refusal of the Court of Appeals in this case to consider such factors places it in conflict with the Court of Appeals for the Tenth Circuit in a case virtually on all fours [*Sorem* v. *Commissioner,* 334 F.2d 275 (10th Cir. 1964)], as well as with another decision from the Eighth Circuit [*Wright* v. *United States,* 482 F.2d 600 (8th Cic. Cir. 1973)].

While the *Sorem* decision antedates this Court's holding in *Davis,* it was not referred to therein, and its factual differences from *Davis* indicate that it remains good law. The *Wright* case was decided after *Davis,* and a petition for certiorari was not authorized by the government. Thus, the first question presented for review is:

1. Where a distribution is not pro rata or proportionate to the distributee's stock interest, does this Court's decision in *Davis* preclude analysis of busi-

ness purpose and other factors in determining dividend equivalency, or is the percentage of reduction in interest the sole factor to be considered?

The Court of Appeals also held that the redemption in this case did not qualify as a "complete redemption of all of the stock of the corporation owned by the stockholder" within the meaning of section 302(b)(3), on the ground that the Fehrs did not file a timely agreement with the Internal Revenue Service as provided by section 302(c)(2)(A)(iii) and Reg. § 1.302-4(a). This holding of the Court of Appeals, Finance submits, conflicts with a prior holding of the Court of Appeals for the Tenth Circuit. [*United States* v. *Van Keppel*, 321 F.2d 717 (10th Cir. 1963)] Therefore, the second question presented for review is:

2. Where the agreement called for by section 302(c)(2)(A)(iii) is not timely filed due to a mistake in law, but is ultimately filed and accepted by the Commissioner, at a time when the purpose to be served by filing such an agreement may still be served, may such agreement be disregarded in determining the applicability of section 302(b)(3) to a redemption which would otherwise qualify as "complete"?

STATUTES AND REGULATIONS INVOLVED

The statutory provisions involved in this controversy are sections 302(a), (b)(1), (b)(3) and (c)(2), 304, 318(a)(1), and 362 of the Internal Revenue Code of 1954, 26 U.S.C. §§ 302(a), (b)(1), (b)(3) and (c)(2), 304, 318(a)(1), and 362. Treasury Regulation § 1.302-4(a) is also involved. The statutes and regulations are quoted in the Appendix hereto.

STATEMENT OF THE CASE

Rental is a Nebraska corporation, all of the 1,380 shares of which were, prior to December 21, 1964, owned by Mr.

Fehrs (1,223 shares) and Mrs. Fehrs (157 shares). As a result of gifts made by Mr. Fehrs in December, 1964 and January, 1965 to his wife, his 2 daughters, his son-in-law, and his 3 grandchildren, Mr. Fehrs' ownership was reduced to 982 shares. Mrs. Fehrs then owned 177 shares, and 221 shares were owned by Mr. Fehrs' son-in-law (25 shares), his 2 daughters (136 shares) and his 3 grandchildren (60 shares).

Finance, the petitioner herein, is a Nebraska corporation, all 19 shares of which were owned by the 2 Fehrs daughters from the time of its incorporation. Neither Mr. Fehrs nor Mrs. Fehrs has ever been a shareholder, officer, director or employee of Finance.

On March 1, 1965, Mr. and Mrs. Fehrs sold to Finance all of the shares in Rental owned by them in exchange for private annuity contracts. On the same date, Mr. Fehrs resigned as president and director of Rental, and since that date, neither he nor Mrs. Fehrs has been a shareholder, officer, director or employee of Rental.

The Rental stock redemption was motivated by Mr. Fehrs' desire to accomplish three objectives: (1) to retire from business altogether; (2) to transfer ownership of Rental to his daughters in substantially equal shares; and (3) to relinquish the management of Rental to his son-in-law. At the same time he wished to maintain a comfortable living for himself and his wife during their remaining lifetimes. Mr. Fehrs was 70 years old at the time of the redemption of his stock in exchange for a private annuity of $62,000 per year for the balance of his life.

The 1,159 shares of Rental purchased by Finance were resold by it on the same day to Rental and were cancelled by Rental on April 16, 1965. Thereafter, all of the shares of Rental were owned by Mr. Fehrs' son-in-law, 2 daughters and 3 grandchildren.

Finance received $100,000 cash and an unsecured promissory note in the face amount of $625,000 from Rental in payment for the Rental shares sold to it by Finance. The Tax Court held, contrary to the contention of Finance, that the transaction constituted a redemption of the Rental stock by Finance subject to sections 304 and 302 of the Internal Revenue Code of 1954. Accordingly, it held that the basis of the Rental stock in the hands of Finance must be determined by reference to its basis in the hands of Mr. and Mrs. Fehrs, increased by the amount of capital gain recognized to them on the transfer. It was stipulated that the basis of the Rental stock in the hands of Mr. and Mrs. Fehrs was zero, and the Tax Court held that no capital gain was realized by Mr. and Mrs. Fehrs on the transfer. The Tax Court refused to consider the business purpose for the redemption, the change of the Fehrs' interest from direct to indirect, their loss of actual control, the elimination of their right to dividends, or any factors other than the percentage reduction in their interest from 98.2% to 88.7%. This reduction, it held, was not "meaningful," as required by the *Davis* case. Thus, the redemption was not a sale under section 302(b)(1) and gave rise to no capital gain. Accordingly, the basis of the Rental stock in the hands of Finance was zero[2] and Finance realized a taxable gain of $100,000 in 1965, based on the cash received in that year on its sale of the Rental stock to Rental.

On October 4, 1972, within 10 days after the entry of the Tax Court's decision, Mr. and Mrs. Fehrs filed with the District Director of Internal Revenue, Omaha, with whom they filed their joint income tax return for the calendar year 1965, an Agreement pursuant to section 302(c)(2)(A)(iii)

[2] An increased basis for gift taxes paid by Mr. and Mrs. Fehrs was allowed by the Tax Court and was affirmed on a cross-appeal by the government. This issue is not involved in this petition.

to give Notification of Future Stock Acquisitions. This Agreement recited the facts of their sale of Rental stock to Finance, stated the absence of any interest in either Finance or Rental, other than as creditors of Finance, and contained an agreement to notify the District Director of any acquisition of such an interest on or prior to March 1, 1975. The Agreement was accepted by the District Director and this acceptance has never been repudiated.

On appeal, Finance abandoned its contention that sections 304 and 302 were not applicable, but contended that the transaction constituted a sale of the Rental stock by Mr. and Mrs. Fehrs under either section 302(b)(1) or (b)(3). Accordingly, it contended that it was entitled to increase its basis for the Rental stock above zero.[3] The Court of Appeals for the Eighth Circuit rejected these contentions and held that the redemption did not qualify under either section 302(b)(1) or (b)(3) and that the basis of the Rental stock remained zero in Finance's hands.[4] The Court of Appeals refused to consider business purpose and other factors in determining dividend equivalency, looking solely to the percentage of reduction from a largely direct interest of 98.2%

[3] The amount of the increase in basis to which Finance would have been entitled was not decided by either the Tax Court or the Court of Appeals, because both held that the transaction did not qualify as a sale under section 302(b)(1) or (3). If this Court were to grant certiorari and reverse the decision of the Court of Appeals, the case should be remanded for a determination as to this issue.

[4] Finance advanced an alternative contention to the effect that, even if the transaction were treated as a distribution of property governed by section 301, the distribution gave rise to gain taxable as capital gain under section 301(c)(3)(A), and that it was therefore entitled to an increase in basis. The Court of Appeals held that no distribution of property was made to Mr. and Mrs. Fehrs in 1965; therefore, they realized no capital gain under that section which could be attributed to Finance in the form of stepped-up basis for the stock. This holding is not questioned by Finance in this petition.

to an indirect interest of 88.7% which, like the Tax Court, it found not to be "meaningful."

The Court of Appeals also rejected Finance's contention that the redemption was "complete" within the meaning of section 302(b)(3), on the ground that the Agreement filed by the Fehrs on October 4, 1972, although accepted by the District Director, was not timely.

REASONS FOR GRANTING THE WRIT

I

THE DECISION OF THE COURT OF APPEALS WITH RESPECT TO SECTION 302(b)(1) IS BASED ON AN ERRONEOUS CONSTRUCTION OF THIS COURT'S HOLDING IN DAVIS AND CONFLICTS WITH A DECISION OF THE COURT OF APPEALS FOR THE TENTH CIRCUIT AND WITH A DECISION BY A DIFFERENT PANEL OF THE COURT OF APPEALS FOR THE EIGHTH CIRCUIT

The Tax Court interpreted this Court's holding in *United States* v. *Davis*, 397 U.S. 301 (1970), extremely broadly:

> *** The Court clearly holds that whenever the dividend equivalency test of section 302(b)(1) is to be applied, business purpose is irrelevant. [58 T.C. at 187]

That Court also held that the change in the Fehrs' interest from a direct controlling interest to an indirect interest was irrelevant. Only the percentage reduction was considered and found not to be "meaningful." The Court of Appeals affirmed the Tax Court on both points.

Petitioner submits that both of the courts below erroneously extended the holding of the *Davis* case, and that business purpose and other factors remain relevant in any situation wherein something other than a pro rata or proportionate distribution is present. Such factors necessarily

bear on the meaningfulness of the reduction in interest in any such case. Petitioner urges this Court to grant certiorari in order to enunciate this principle.

A Comparable Petition Has Not Been Submitted To This Court

Although a number of petitions for certiorari have been denied by this Court in cases involving section 302(b)(1), each of these has presented a factual situation virtually identical to that in *Davis. Brown* v. *United States*, 345 F.Supp. 241 (S.D. Ohio 1972), affirmed without opinion, 477 F.2d 599 (6th Cir. 1973), certiorari denied, 38 L.Ed.2d 250 (1973), involved a series of redemptions of preferred stock. These redemptions, over a number of years, actually increased the taxpayers' percentage of ownership and, even restricting analysis to a few key years focused on by the taxpayers, only reduced their ownership of the preferred stock from 30.16% to 29.16%. The redemptions had no effect on the taxpayers' percentage of voting control or their percentage ownership of common stock. The redemptions were thus virtually pro rata.

Coates Trust v. *Commissioner*, 73-2 U.S.T.C. ¶ 9492 (9th Cir. 1973), certiorari denied, 38 L.Ed.2d 336 (1973), similarly, was a case in which the Court of Appeals held:

> The instant transaction resulted in no reduction of any of the taxpayers' proportionate interests in WIP. That being the case, the Tax Court correctly concluded that the distribution did not qualify for the preferred treatment under § 302(b)(1).

Finally, *Miele* v. *Commissioner*, 56 T.C. 556 (1971), affirmed without opinion, 474 F.2d 1338 (3d Cir. 1973), certiorari denied *sub nom. Albers* v. *Commissioner*, 94 S.Ct. 279, 38 L.Ed.2d 225 (1973), involved a pro rata redemption of preferred stock and was clearly within the scope of

the *Davis* rule. Those three Justices who dissented from the denial of certiorari in *Albers* (Mr. Justice Powell, Mr. Justice Douglas and Mr. Justice Blackmun) urged the Court to reconsider the *per se* rule of *Davis*, so that factors such as business purpose could be taken into account even "where there is no change in the relative economic interests or rights of the stockholders." [94 S.Ct. at 280] Although the Court declined to reconsider *Davis* in a pro rata redemption situation, it has yet to be presented with an opportunity to discuss the relevance of business purpose and other factors as bearing upon the "meaningfulness" of a reduction in interest or a change from a direct to an indirect interest resulting from a non-pro rata redemption. Petitioner submits that such factors are extremely relevant in determining the dividend equivalency of any disproportional distribution, and urges the Court to grant certiorari in this case to so rule.

The Decision of the Court of Appeals Conflicts With Other Decisions

The most nearly "white horse" case to that before this Court is that of *Sorem* v. *Commissioner*, 334 F.2d 275 (10th Cir. 1964). That case, like the present, involved a redemption through a related corporation. Sorem and Boogaart each owned 50% of the stock of Company A; each, with his children, owned a large interest in Company B. Each sold his stock of Company A to Company B. After the transaction, taking into account stock attributed to each through his children, Sorem owned 37.91% of Company A and Boogaart owned 43.77%. Before the transaction, they collectively owned 100% of Company A; afterward, they owned 81.68%.

The Court of Appeals for the Tenth Circuit reviewed the facts that each had been reduced from a direct interest

to an indirect interest in Company A; that each had had a reduction in percentage interest; that each had suffered a loss of actual control over Company A; and that there was a valid business reason for the transaction. These factors, it concluded, justified a holding that the redemption was not essentially equivalent to a dividend. To the same effect as *Sorem* is *Salvatori* v. *United States,* 66-2 U.S.T.C. § 9670 (S.D. Cal. 1966).

In its opinion in the instant case, the Court of Appeals for the Eighth Circuit did not make reference to *Sorem,* although that decision was discussed and relied on by Finance. The Court of Appeals, however, refused to look at any of the factors which its sister court had found controlling, specifically stating that business purpose was irrelevant, and holding simply that a reduction from a direct interest of 98.2% to an indirect interest of 88.7% must be treated as meaningless under the doctrine of the *Davis* case. Although the *Sorem* decision was rendered prior to *Davis,* Finance submits that *Davis* has not overruled *Sorem,* and that the conflict between that decision and the decision below should be resolved by this Court.

In this connection, it should be noted that the District Court in *Brown* v. *United States,* 345 F.Supp. 241 (S.D. Ohio 1972), affirmed without opinion, 477 F.2d 599 (6th Cir. 1973), certiorari denied, 38 L.Ed.2d 250 (1973), accepted the continuing vitality of *Sorem,* citing it for the proposition that:

> Where redemptions have resulted in a *meaningful reduction* of the redeeming shareholder's proportionate interest in a corporation, or have effected a distribution of earnings and profits to him which is not reasonably pro-rated in relation to other shareholders' proportionate interests, they have been viewed as more resembling a sale than a dividend. [345 F.Supp. at 244]

In addition, the holding of the Eighth Circuit in this case is in apparent conflict with another recent decision by a different panel of the same Court, although that panel also erroneously concluded that "business purpose" has no relevance in any section 302(b)(1) decision. *Wright* v. *United States*, 482 F.2d 600 (8th Cir. 1973), is the only decision of which Finance is aware since *Davis* in which a redemption has been held *not* to be essentially equivalent to a dividend. In that case, A owned 99.2% of F & G Company and 56% of W. These two companies were consolidated into Omni, in which A had 85% of the stock. A then sold sufficient Omni stock to Omni to reduce his ownership to 61.7%.

Although the Court said that "business purpose" is no longer a valid test, it went on to say:

> • • • We read that language and *Davis* as holding that the proper inquiry is the percentage change of ownership in the corporation *and the attendant overall results due to that change*. Stated otherwise, the basic inquiry is whether the distribution has the "net effect" of a dividend. • • •
>
> We think that if a distribution is not to have the "net effect" of a dividend, there must have occurred a meaningful reduction of the redeeming shareholders' proportionate interest or in other words a meaningful change in the relative economic interest or rights of the shareholder after the redemption. • • • We further think that it is improper to refer to the "net effect" standard as the "net economic test," as in *Brown* v. *United States*, since a meaningful change in shareholders' voting power is a relevant inquiry. [345 F. Supp. at 609; emphasis supplied]

The Court relied heavily upon *Estate of Arthur H. Squier*, 35 T.C. 950 (1961), where the taxpayer's ownership was reduced by redemption only from 63.3% to 56.82%, but where his direct ownership went below 50%. This less than 7% reduction in interest was held by the Tax Court in

Squier to cause the transaction not to be essentially equivalent to a dividend. In reliance upon that reasoning, the Court of Appeals in *Wright* noted that the taxpayer's reduction in interest from 85% to 61.7% caused a meaningful reduction in his voting power, even though his interest remained direct, because he was no longer assured of the necessary ⅔ vote required to authorize certain corporate actions.

It also noted that the taxpayer's nearly complete control of F & G was reduced to only 61.7% control of Omni, although his 56% control of W was *increased* to 61.7% of Omni. It held, correctly, that there is no *per se* rule as to the necessary percentage reduction of ownership required to assure that a redemption does not have the effect of a dividend, and noted that there had been, in the case before it, a 23.3% reduction in the taxpayer's right to dividends and to assets upon liquidation. In short, the Court looked at, and was governed by, numerous factors to determine whether a reduction in direct ownership was "meaningful." Surely, where there is both a reduction in percentage of ownership and a shift from direct ownership to indirect ownership, such additional factors should not be ignored as they were by the courts below.

II

THE DECISION OF THE COURT OF APPEALS WITH RESPECT TO SECTION 302(b)(3) CONFLICTS WITH A DECISION OF THE COURT OF APPEALS FOR THE TENTH CIRCUIT AND WITH THE INTENT OF CONGRESS

Under section 304, Rental is the corporation to be looked to in determining whether the test of section 302(b)(3) was met in the redemption of its stock. There has never been any dispute over the fact that, following the transfer of

their stock to Finance, neither Mr. Fehrs nor Mrs. Fehrs had any interest in Rental (including an interest as an officer, director or employee). Moreover, even with respect to Finance, neither of them had an interest (including an interest as an officer, director or employee), other than an interest as a creditor.

However, the daughters and grandchildren of Mr. and Mrs. Fehrs did own stock of Rental which, under section 318(a)(1), would have been attributed to them, thus preventing the redemption from being "complete", unless the requirements of section 302(c)(2)(A) were met. The third such requirement is that "the distributee, at such time and in such manner as the Secretary or his delegate by regulations prescribes, files an agreement to notify the Secretary or his delegate of any acquisition described in clause (ii) and to retain such records as may be necessary for the application of this paragraph." At the time of trial, no such agreement had been filed for the obvious reason that, until the conclusion of the trial and the handing down of the Tax Court's decision, Mr. and Mrs. Fehrs and Finance consistently took the position that sections 304 and 302 were not applicable to the sale of the Rental stock to Finance by Mr. and Mrs. Fehrs. If section 302 was not applicable, there was no need to file a section 302(c)(2)(A)(iii) agreement.

When the Tax Court held that sections 304 and 302 did apply, the agreement called for was immediately filed.

Despite the filing of the agreement, however, the Court of Appeals held that section 302(b)(3) was inapplicable, because the agreement was filed so tardily as not to be in substantial compliance with the requirements of section 302(c)(2)(A)(iii) and Reg. § 1.302-4(a). The court purported to distinguish *United States* v. *Van Keppel*, 321F.2d

717 (10th Cir. 1963); *Georgie S. Cary*, 41 T.C. 214 (1963); and *Pearce* v. *United States*, 226 F.Supp. 702 (W.D. N.Y. 1964), upon which Finance relied, on the ground that each of them involved a case "wherein taxpayers were allowed to file tardy agreements before the law suits were tried." Finance submits that this is not a real distinction, and that the holding of the Court of Appeals in the instant case presents a conflict with the holding of the Court of Appeals for the Tenth Circuit which this Court should resolve.

In *Van Keppel*, a husband owned 1,124, and a wife owned 375, of the 2,000 authorized shares of stock in a corporation. The corporation redeemed all of the wife's shares in 1956, and the transaction was reported as giving rise to capital gain, but no section 302(c)(2)(A)(iii) agreement was filed, notwithstanding the fact that there was no question but that the redemption fell under section 302. In 1958, on audit of the 1956 return, the taxpayer was informed of the absence of an agreement and promptly filed one at that time. The Court of Appeals held that the agreement was effectively filed and that the redemption, therefore, qualified under section 302(b)(3) for capital gain treatment. It stated the applicable principles of law as follows:

> The statute empowers the Secretary to fix by regulation the time when the agreement was filed. The regulation requires that the agreement accompany a "return timely filed." The regulation is reasonable and assures compliance with the statutory scheme. The taxpayers have no absolute right to file the agreement after the period has expired for the filing of the return covering the year in which the distribution occurred. Otherwise, the taxpayers could gamble on the probability of an audit of the return within the period fixed by § 6501.
>
> Nothing in the statutes or regulations precludes the Director from accepting an agreement filed after the prescribed period. Established administrative practice

has long recognized and accepted amended returns filed after the due date "for the purpose of correcting clear errors or plain mistakes inhering in original returns." See Klinghamer v. Broderick, 10 Cir., 242 F.2d 563, 564. In J. E. Riley Investment Co. v. Commissioner of Internal Revenue, 311 U.S. 55, 58, 61 S. Ct. 95, 97, 85 L.Ed. 36, the Supreme Court referred to the liberality of the Treasury in accepting amended returns, even though filed after the period for filing original returns when the amendment was "designed merely to correct errors and miscalculations in the original return."

Although both the Klinghamer and Riley cases sustained the rejection of an amended return, those cases dealt with a change of election. Here we have a mistake—not a change of election. The interests of the government have not been jeopardized. The Commissioner has neither misled or inconvenienced. *Had the mistake not been made, the taxpayers would have been entitled to have the transaction treated as a capital gain.*

The Director did not reject the agreement or the amended return. Unless the assessment of the deficiency may be considered a rejection, the government has never disclaimed the agreement and the taxpayers are bound by it. * * *

In the circumstances we are reluctant to believe that the mistake was irrevocable. Acceptance of the late filing was discretionary. Fairness to the taxpayers requires that the discretion be exercised for their benefit and failure to do so was an abuse of discretion.

[321 F.2d at 720, emphasis supplied]

While the agreement in *Van Keppel* was filed two years late and before trial, whereas the agreement here was filed six years late and after a Tax Court trial, the basic similarity between the two cases is apparent. In neither case was the agreement timely; to distinguish between them on the ground that the agreement here was more tardy than the

one in *Van Keppel* is to open Pandora's box. What if the agreement here were four, three, or two and one-half years late? At what point would the Court of Appeals for the Eight Circuit find the case comparable to *Van Keppel?* The period of delay in filing the agreement does not sustain a distinction between the cases.

Further, in *Van Keppel,* the delay was due purely to inadvertence; there was no question but that the redemption was governed by section 302 and that a section 302(c)(2)(A)(iii) agreement was required to make section 302(b)(3) applicable. In the instant case, the delay was far more excusable, being due to a mistake of law, i.e., a belief that section 302 was not applicable to the transaction because it was not a section 304 redemption. As stated in *Van Keppel,* "Had the mistake not been made, the taxpayers would have been entitled to have the transaction treated as a capital gain."

When their mistake of law became clear upon the entry of a decision by the Tax Court, the agreement was filed by the Fehrs as promptly as the agreement in *Van Keppel* when its absence was called to the taxpayer's attention on audit. The agreement was accepted by the District Director and the Fehrs are bound by it. If there is any ground for distinction between the instant case and *Van Keppel,* it is that the instant case more urgently calls for acceptance of the late filing in the name of fairness to the taxpayers.

In this connection, the legislative history of section 302(c)(2), discussed by the Tax Court in the *Cary* case, is extremely pertinent. The Tax Court noted:

> *** The *essence* of section 302(c)(2) taken in conjunction with section 302(b)(3) is to allow exchange treatment to redemptions which result in the complete cessation of a shareholder's interest in a corporation for a period of 10 years. In this connection, we observe that section 302, as *originally* enacted by the House, pro-

vided that the rules of family attribution [now section 318(a)(1)] would not be applicable to redemptions in complete termination of a shareholder's interest if only *two* conditions were met, viz, that "immediately [after the redemption] * * * the distributee has no interest in the corporation *** and *** such distributee does not acquire any such interest in [the] corporation within 10 years from the date of the distribution in redemption." [H. Rept. No. 1337, 83d Cong., 2d Sess., p. A75 (1954)]. We further note that the *House* version of the statute exacted *no* requirement that an agreement be filed with the Secretary or his delegate before "complete termination" redemptions would qualify for exemption from the family attribution rules.

The *Senate* version of section 302 retained the two *essential* requirements for the exemption of redemptions in complete termination from the family attribution rules, and added a third provision, relating to the filing of an agreement, with this explanation:

Moreover, in order to qualify for nonattribution between members of a family, sub-paragraph (A)(iii) [of section 302(c)(2)] requires that the distributee, under regulations prescribed by the Secretary or his delegate, file an agreement to notify the Secretary or his delegate of any acquisition of any interest (other than by bequest or inheritance) within the 10 year period and to retain such records as the Secretary or his delegate may prescribe as necessary for the application of paragraph (2) [of section 302(c)]. *Thus, your committee anticipates that the Secretary or his delegate may require that the distributee retain personal income tax returns and other records indicating fully the amount of tax which would have been payable and the redemption not been treated as a distribution in full payment for his stock.* [S. Rept. No. 1622, 83d Cong., 2d Sess., p. 236 (1954) Emphasis supplied.]

It would thus appear that a primary purpose for the addition of section 302(c)(2)(A)(iii) to the House version of section 302 was so that records, "indicating fully the amount of tax which would have been payable had

> the redemption not been treated as a distribution in full payment for his stock," could be required of distributees by the Commissioner of Internal Revenue.
>
> As we have hereinbefore noted, what is essential with respect to sections 302(b)(3) and (c)(2) is that the redemption result in the complete cessation of the shareholder's interest in the corporation, and, that such cessation extend for a period of 10 years. The requirement that the distributee agree to retain records of the redemption does not relate to the substance of the transaction, but, on the contrary, relates merely to procedural detail. Such a requirement can, in our view, be satisfied by substantial compliance with its provisions. (41 T.C. at 218-219)

Since the agreement filed by Mr. and Mrs. Fehrs recites that neither has acquired a proscribed interest in Rental or Finance since the redemption of the Rental stock, and since each agree to maintain the required records, the Commissioner has not been prejudiced by its delayed filing. Substantial compliance with the statute has been achieved, and section 302(b)(3) should, therefore, be applicable.

CONCLUSION

For each of the foregoing reasons, petitioner earnestly urges that this petition be granted and that this Court's writ of certiorari issue to the Court of Appeals for the Eighth Circuit to review its decision in the instant case.

Respectfully submitted,

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APPENDIX J

TAX COURT OPINION

UNITED STATES TAX COURT

FEHRS FINANCE COMPANY, PETITIONER v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 2136—69. Filed May 1, 1972.

EF and VF, husband and wife, owned all the stock in R, a corporation. Within a period of about 3 months, (1) EF gave some of his stock to VF, and to their son-in-law, daughters, and grandchildren, (2) the petitioner was incorporated, with the daughters of EF and VF as the sole shareholders, (3) EF and VF transferred the remainder of their stock in R to the petitioner in return for the petitioner's promise to pay them lifetime annuities, and (4) the petitioner sold all of the stock so acquired to R, in exchange for cash and a note, and R canceled such stock. *Held:* (1) The transaction in which the petitioner obtained the R stock from EF and VF constituted a redemption through the use of a related corporation under sec. 304(a)(1), I.R.C. 1954; (2) such redemption did not qualify for treatment as an exchange under either sec. 302(b)(1) or sec. 302(b)(3), I.R.C. 1954; thus, the annuity payments are treated as distributions of property to which sec. 301, I.R.C. 1954, applies; and (3) the petitioner's basis in the R stock equals EF's and VF's basis in such stock (which was zero) plus the amount of the gain which EF and VF recognized under sec. 301(c)(3), I.R.C. 1954, on the transfer of their stock to the petitioner. However, in the year of the transfer, no actual annuity payments were made, and EF and VF were

not required to recognize any gain as a result of the making of the annuity agreements. The tax treatment of each of the annuity payments made in a subsequent year will be governed by circumstances existing in such year and not by the amount of the petitioner's earnings and profits, or lack thereof, in the year of the transfer; thus, there is no reasonably reliable way to predict to what extent the annuity payments will be treated as gain rather than as dividends to EF and VF. Therefore, for the year of the transfer, the petitioner's basis in the stock is zero.

William A. Cromartie and *William E. Barrows,* for the petitioner. *James T. Finlen, Jr.,* for the respondent.

SIMPSON, *Judge:* The respondent has determined a deficiency of $32,459.07 in the petitioner's Federal income tax for the year ended November 30, 1965. In a transaction which we conclude was a redemption under section 304(a)(1) of the Internal Revenue Code of 1954,[1] the petitioner acquired stock in exchange for a promise to pay two annuities, and immediately thereafter it sold such stock prior to making any annuity payments. To determine the petitioner's basis in such stock, we must decide whether the redemption was essentially equivalent to a dividend under section 302(b)(1), whether the transferors of the stock completely terminated their interest in the corporation within the meaning of section 302(b)(3), and how much gain, if any, was recognized by the transferors on the transfer within the meaning of section 362(a).

FINDINGS OF FACT

Some of the facts have been stipulated, and those facts are so found.

[1] All statutory references are to the Internal Revenue Code of 1954, unless otherwise indicated.

The petitioner, Fehrs Finance Co., is a Nebraska corporation which had its principal place of business at Omaha, Nebr., when the petition was filed in this case. It filed its Federal income tax return for the taxable year ended November 30, 1965, using the cash method of accounting, with the district director of internal revenue, Omaha, Nebr.

Fehrs Rental Co. (Rental)[2] is a corporation which was incorporated in Nebraska in 1954, primarily to rent, lease, sell, and repair road and industrial construction equipment. Prior to December 21, 1964, Edward J. Fehrs owned 1,223 of the 1,380 outstanding shares of Rental, and his wife, Violette E. Fehrs, owned the remaining 157.

On December 21, 1964, Mr. Fehrs gave a total of 130 shares of Rental to certain of his relatives, as follows: 10 to Mrs. Fehrs; 15 to his son-in-law, William R. Vleek; 15 to his daughter, Mary Jane Vleek; 10 each to his 3 grandchildren, William Vleek, Jr., Linda Vleek, and Sharon Vleek; and 60 to his daughter, Elizabeth Fehrs May. On January 11, 1965, he gave an additional 111 shares of Rental to such relatives, as follows: 10 to Mrs. Fehrs; 10 to Mr. Vleek; 11 to Mrs. Vleek; 10 each to the same 3 grandchildren; and 50 to Mrs. May. After such gifts were made, Mr. Fehrs owned 982 shares of Rental, Mrs. Fehrs owned 177, and 221 shares were owned by his son-in-law, his daughters, and his grandchildren.

On February 28, 1965, the petitioner was incorporated in Nebraska. Its principal business has been the acquisition of commercial paper generated by sales of construction equipment by Rental. Upon its organization, the petitioner issued

---

[2] In about 1960, Rental merged with another corporation, Fehrs Tractor & Equipment Co., with Rental being the surviving corporation. Pursuant to an amendment of the articles of incorporation on Mar. 1, 1965, Rental changed its corporate name to Fehrs Tractor & Equipment Co. However, for purposes of clarity, we shall refer to such corporation consistently as "Rental."

19 shares of capital stock at $100 each. Ten of such shares were subscribed to and paid for at par value by Mrs. May, and nine of such shares were subscribed to and paid for at par value by Mrs. Vlcek. Neither Mr. Fehrs nor Mrs. Fehrs has ever been a shareholder, officer, director, or employee of the petitioner.

On March 1, 1965, Mr. and Mrs. Fehrs transferred their remaining shares in Rental to the petitioner. On that date, their basis in the stock of Rental was zero. In return for the 982 shares it acquired from Mr. Fehrs, the petitioner promised to pay him the amount of $62,000 per year, payable $15,500 quarterly, beginning January 1, 1966, and continuing for the remainder of his life. In return for the 177 shares it acquired from Mrs. Fehrs, the petitioner promised to pay her the amount of $8,000 per year, payable $2,000 quarterly, beginning January 1, 1966, and continuing for the remainder of her life. The agreements by which the petitioner agreed to make such payments to Mr. and Mrs. Fehrs (the annuity agreements) were authorized by the petitioner's board of directors at its first meeting on March 1, 1965, and such agreements were signed by Mr. Vlcek in his capacity as the petitioner's president, to which position he had been elected at that meeting.

Later, on March 1, 1965, there was a special meeting of the board of directors of Rental, at which Mr. Fehrs resigned as president and as a director. The minutes of such meeting indicated that Mr. Fehrs "had reached retirement age and had decided to terminate his relationship with the corporation." Since such time, Mr. Fehrs has been retired, and neither he nor Mrs. Fehrs has been a shareholder, officer, director, or employee of Rental. Also at such meeting, Mrs. Vlcek was elected to fill Mr. Fehrs' unexpired term on the board, and Mr. Vlcek was elected to succeed Mr. Fehrs as president.

The annuity agreement pertaining to Mr. Fehrs contained substantially the same terms as that pertaining to Mrs. Fehrs. The annuity agreements provided that if the petitioner defaulted in making any payment due thereunder, and the default continued for 30 days, the "entire commuted value of the annuity" would be immediately due and payable, "such commuted value to be computed in accordance with standard actuarial tables and values taking into account the age of the annuitant as of the date of default." Such default provision could be waived in writing by the annuitant. The annuity agreements provided further that neither such agreements nor the payments to be made thereunder could be negotiated, assigned, or anticipated by the annuitants, and that the petitioner would have no obligation to recognize or give effect to any such purported negotiation, assignment, or anticipation.

Mr. Fehrs was born on December 5, 1894, and Mrs. Fehrs was born on July 9, 1900. If the petitioner desired, in 1965, to purchase commercial annuities for Mr. and Mrs. Fehrs to discharge all of its liabilities to them under the annuity agreements, such commercial annuities would have cost the petitioner approximately $550,000 for Mr. Fehrs, and approximately $105,000 for Mrs. Fehrs, or a total of approximately $655,000. On the books and records of the petitioner, and on its corporate income tax return for the taxable year ended November 30, 1965, the obligation to Mr. and Mrs. Fehrs was reflected as a liability as of March 1, 1965, in the total amount of $725,000.

On March 1, 1965, the same day on which it acquired the 1,159 shares of Rental from Mr. and Mrs. Fehrs, the petitioner and Rental executed a document entitled "Redemption Agreement." Pursuant to the terms of such document, the petitioner transferred to Rental the 1,159 shares of such corporation. In exchange for such stock, Rental transferred

to the petitioner the sum of $100,000 in cash, and an unsecured negotiable promissory note of Rental in the principal sum of $625,000. The note provided for annual payments of principal and interest. Each principal payment was set at 5 percent of the original principal or 25 percent of Rental's annual net income after Federal income taxes, whichever was greater: the interest rate was 7 percent per annum. The annual payments were to be made on January 2 of each year, commencing with 1966.

On the books and records of the petitioner, the $625,000 note of Rental was treated as a contract receivable. On its Federal corporate income tax return for the taxable year ended November 30, 1965, such note was included in the category of notes and accounts receivable.

The 1,159 shares of Rental which it acquired from the petitioner were canceled on April 16, 1965, pursuant to a resolution adopted by Rental's board of directors. After such cancellation, 221 shares of Rental remained outstanding, and those shares were owned by Mr. and Mrs. Fehrs' daughter, son-in-law, and grandchildren, as a result of the gifts by Mr. Fehrs in 1964 and 1965.

Rental's Federal income tax return for the taxable year ended September 30, 1964, shows that its earned surplus and undivided profits at the close of such year amounted to $1,229,103.78. Its return for the taxable year ended September 30, 1965, shows that its earned surplus and undivided profits would have amounted to $1,410,149.20 at the close of that year, but for the "reduction of capital" in the amount of $609,100 during the year. It paid no dividends to its shareholders from the time of its incorporation until January 2, 1966.

Except for its ownership of the 1,159 shares as described, the petitioner has never owned any stock of Rental; and Rental has never owned any stock of the petitioner.

In December 1965, Rental was advised that the petitioner had requested a prepayment to the extent of $300,000 with respect to the principal amount owed by Rental to the petitioner pursuant to the Redemption Agreement. The petitioner agreed, in consideration of such prepayment, to waive any interest due and owing on the balance of the principal sum for a 5-year period from December 1, 1965. On December 27, 1965, Rental made the prepayment of $300,000 to the petitioner on those terms. Subsequently, Rental made further payments of principal to the petitioner as follows: $41,122 on January 3, 1966; $35,560.16 on January 11, 1967; and $31,250 on December 14, 1967.

At an annual meeting of the petitioner's board of directors on December 27, 1965, the directors discussed in detail a copy of a preliminary profit-and-loss statement for the year ended November 30, 1965. After the discussion, the directors declared a dividend at the rate of $4,000 per share payable January 2, 1966, to the shareholders of record on November 30, 1965. During the calendar years 1966, 1967, and 1968, the petitioner paid dividends in the total respective amounts of $76,000, $38,000, and $38,000 to its shareholders; such amounts were paid ten-nineteenths to Mrs. May and nine-nineteenths to Mrs. Vlcek. After treating the dividends paid in 1966 as recoveries of their bases to the extent applicable, both of them treated the dividends as long-term capital gains in their own Federal income tax returns for 1966 and 1967, and Mrs. Vlcek, at least, did the same for 1968.

The petitioner's books and Federal income tax returns showed increased deficits in the category of earned surplus and retained earnings, as follows:

YEAR ENDED NOV. 30

	1965	1966	1967	1968
Balance at beginning of year	0	($95,033.32)	($133,305.21)	($174,449.68)
Net income as shown on books	($19,033.32)	(271.89)	(3,144.47)	(9,850.82)
Cash distributions to shareholders during year ...	76,000.00	38,000.00	38,000.00	38,000.00
Balance at end of year ..	(95,033.32)	(133,305.21)	(174,449.68)	(222,300.50)

Such figures were based on the assumptions that none of the amounts received from Rental on account of the stock transfer constituted gain which should be reflected in the petitioner's earnings and profits, and that all of the distributions made by the petitioner to its shareholders when the corporation apparently lacked earnings and profits should serve to increase the deficit balance in the earned surplus and retained earnings account.

The district director of internal revenue, Omaha, Nebr., determined deficiencies in the gift taxes of both Mr. and Mrs. Fehrs for the year 1965, in the amounts of $28,700.42 and $22,214.94 respectively. Such deficiencies were based on the following computations by him: That on March 1, 1965, the stock of Rental was worth $700 per share; that the total values of the stock transferred by Mr. and Mrs. Fehrs respectively were $687,400 and $123,900; that the actuarial values of the annuities received by Mr. and Mrs. Fehrs respectively were $474,319.76 and $78,054.08; and that the differences between the values of the stock and the annuities constituted gifts to the shareholders of the petitioner by Mr. and Mrs. Fehrs in the respective amounts of $213,080.24 and $45,845.92.

Mr. and Mrs. Fehrs paid the gift tax deficiencies in the amounts determined by the district director, and on April

14, 1969, they each filed a claim on Form 843 for the refund of the gift taxes paid pursuant to the deficiency determinations, in addition to other gift taxes which they paid along with returns filed on April 15, 1966, plus interest. In such claims, the Fehrses alleged that the respondent erred in concluding that a gift resulted from the exchange of Rental stock for the annuity.

In 1966, 1967, and 1968, Mr. and Mrs. Fehrs received their annuity payments from the petitioner as called for by the annuity agreements. In their joint Federal income tax returns for 1966 and 1967, Mr. and Mrs. Fehrs reported the annuity payments in the following manner:

	Mr. Fehrs	*Mrs. Fehrs*
As annuity income:		
Investment in contract	$687,400.00	$123,900.00
Expected return	719,200.00	145,600.00
Percent of income to be excluded	95.58	85.10
Amount received this year	$ 62,000.00	$ 8,000.00
Amounts excludable	59,260.00	6,808.00
Taxable annuity income	2,740.00	1,192.00
As long-term capital gains received in current year:		
982 shares of Rental sold 3/1/65	59,260.00	
177 shares of Rental sold 3/1/65		6,808.00

Mr. and Mrs. Fehrs' joint Federal income tax return for 1966 was examined by the respondent. A report of the examination, mailed to Mr. and Mrs. Fehrs on March 13, 1968, proposed adjustments resulting in a deficiency in income tax. The principal reason for such adjustments was the determination that the $70,000 in annuity payments received by the Fehrses in 1966 actually represented a "distribution essentially equivalent to a dividend," and that such payments should therefore be taxed as ordinary income, not as capital gain and annuity income. The report termed the 1965 transaction in which the stock was exchanged for the annuities as a "sham," and alleged that the dividend came

from a "source other than the annuity." Mr. and Mrs. Fehrs executed a waiver of the restrictions on assessment and collection of the deficiency, and thereafter, they paid the deficiency and interest thereon. On June 30, 1969, Mr. and Mrs. Fehrs filed a claim for refund of the amount of such deficiency and interest; they alleged that the district director "erred in his determination that the taxpayers received 'dividend income (redemption of capital stock) $70,000' during the taxable year [1966]."

The gifts of his stock in Rental that Mr. Fehrs made to his wife, daughters, son-in-law, and grandchildren in December 1964 and January 1965 were made upon the advice of counsel; the amounts of such gifts were also determined upon the advice of counsel. At the time such gifts were made, Mr. Fehrs anticipated that he would retire from business in March 1965. He and his wife were concerned about their having sufficient income to live after his retirement, and about the manner in which ownership of Rental would pass to their daughters and son-in-law; the latter had been working for Rental for a substantial number of years. Mr. Fehrs was concerned that no outside party would be interested in buying a corporation such as Rental; he felt that the alternatives were to liquidate it or to carry it on within the family. He also desired that the petitioner have a means of obtaining operating capital. Mr. and Mrs. Fehrs discussed these problems, as well as the matter of annuities, with their counsel prior to making the exchange. In fact, their counsel planned the formation of the petitioner and has assisted in the planning of its affairs.

For its taxable year ending November 30, 1965, the petitioner reported no gain or loss on account of the sale of the Rental stock. In the notice of deficiency in this case, the respondent determined that the petitioner realized a short-term capital gain in the amount of $725,000 from the alleged

sale of the stock of Rental during the year in issue; the respondent determined that the petitioner should have recognized such gain in that year to the extent of the amount of the cash received: $100,000. The alleged gain of $725,000 is based on the theory that the petitioner's basis in the Rental stock was zero, and that its sales price on March 1, 1965, was $725,000, with $625,000 of such price being deferred.

OPINION

The issue ultimately to be decided in this case appears to be simple: Did the petitioner realize a capital gain on the sale of the Rental stock in 1965? However, to reach that ultimate issue, we must work our way through an amazing maze of preliminary issues. At no time has the respondent taken the position that Rental's acquisition of its stock constituted a redemption under section 302 and that the payments received by the petitioner should be treated as dividends; at all times, he has treated such payments as a capital gain. The controversy revolves about the petitioner's basis in the stock. The respondent contends that section 304 is applicable to the petitioner's acquisition of stock from Mr. and Mrs. Fehrs and that its basis in such stock is therefore determined under sections 304 and 362(a). He concedes that if section 304 is applicable to the petitioner's acquisition of such stock, the gain which it realized on the transfer of such stock to Rental is taxable as a long-term capital gain. Thus, the initial issue for us to consider is whether section 304 is applicable to the petitioner's acquisition of the stock.

Section 304(a)(1) provides in relevant part that, if one or more persons are in "control" of each of two corporations, and if one of those corporations acquires stock in the other corporation from the person or persons in control, then the transaction shall be treated as a redemption under

section 302. The stock shall be treated by the acquiring corporation as having been received as a contribution to its capital. The term "control" is defined in section 304(c)(1) as "the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of shares of all classes of stock." Furthermore, section 304(c)(2) states that the rules contained in section 318(a) with respect to the constructive ownership of stock shall apply for the purpose of determining "control," except that the 50-percent limitations of sections 318(a)(2)(C) and 318(a)(3)(C) shall be disregarded for such purpose. Section 318(a) provides that an individual shall be considered as actually owning the stock which is owned by his spouse, his children, and his grandchildren.

Section 304(a)(1) applies to what is commonly referred to as a "redemption by related or brother-sister corporations." It is clear that by its terms, such section applies to the factual situation in this case. Immediately prior to the transactions here in issue, Mr. and Mrs. Fehrs actually owned 1,159 of the 1,380 outstanding shares of Rental, and their daughters and grandchildren owned 196 shares; thus, a total of 1,355 shares, or 98.2 percent of the outstanding stock, was actually or constructively owned by either Mr. Fehrs or Mrs. Fehrs. Only the 25 shares owned by Mr. Vleek were not attributed to either of the Fehrses under section 328(a). All of the outstanding shares of the petitioner were owned by the daughters of the Fehrses, and were, therefore, similarly attributable to Mr. Fehrs or Mrs. Fehrs. Thus, either Mr. Fehrs or Mrs. Fehrs, or both, were regarded as the person or persons in control of both the petitioner and Rental prior to the transactions in issue. The transaction in which the petitioner acquired stock in Rental from Mr. and Mrs. Fehrs in return for the annuities must be treated as a redemption, and the stock of Rental so ac-

quired must be treated as having been transferred by Mr. and Mrs. Fehrs to the petitioner as a contribution to its capital, under the express mandate of section 304(a)(1). See *Rose Ann Coates Trust,* 55 T.C. 501 (1970), on appeal (C.A. 9, June 17, 1971); *Ray A. Maher,* 55 T.C. 441 (1970), on appeal (C.A. 8, Oct. 12, 1971); *Ralph L. Humphrey,* 39 T.C. 199 (1962).

The petitioner's only serious objection to the applicability of section 304 is its contention that the respondent is estopped from raising such issue in this case by reason of his action in asserting and collecting a deficiency in gift tax from Mr. and Mrs. Fehrs on the basis that their transfer of the Rental stock to the petitioner constituted a gift in part. There has been a good deal of confusion in the development of the issues in respect of the petitioner's acquisition of stock from Mr. and Mrs. Fehrs and its sale of such stock to Rental. At first, the respondent took the position that the transfer of stock by Mr. and Mrs. Fehrs was in part a sale and in part a gift to the shareholders of the petitioner. Later, he changed his attack: with respect to the income tax liability of Mr. and Mrs. Fehrs for the year 1966, he took the position that the $70,000 distributed to the Fehrses in such year was a "redemption distribution essentially equivalent to an ordinary dividend." In the notice of deficiency which led to this case, the respondent determined that the entire gain recognized by the petitioner in 1965 was taxable; although the notice said nothing expressly about the applicability of section 304, the result was apparently based on the premise that such section was applicable. In his opening statement in the trial of this case, the respondent's counsel did expressly adopt the position that section 304 is applicable. The petitioner contends that since the respondent initially took the position that such transfer was a sale and a gift, he cannot now contend that the transaction was a redemption. On the other hand, the

respondent argues that since Mr. and Mrs. Fehrs have filed claims for refund of the gift taxes paid by them in which they alleged that no such gifts were made, the petitioner cannot now argue that the transfer was in part a gift.

So far as we know, the claims for refund are still pending, and there has been no final disposition of them. Since the Fehrses' gift tax liability has been challenged and the collection of that tax is not irrevocable, we need not even reach the question as to the consequences of an irrevocable payment of such tax: here, it is clear that the respondent's assertion of such liability cannot work an estoppel in this case and does not impose upon him any duty of consistency. Inasmuch as both the respondent's claims in the other proceedings and the claims by Mr. and Mrs. Fehrs are still to be adjudicated, it seems that the appropriate course for us is to disregard the positions taken by the parties in those proceedings and to adjudicate this case in accordance with the law and the facts presented to us. Our conclusions will no doubt be taken into consideration in the final adjudication of those other claims. Accordingly, we hold that section 304 is applicable to the petitioner's acquisition of the Rental stock.

In view of that conclusion, we now reach the question as to what was the petitioner's basis for the Rental stock under section 304. The petitioner must treat the stock as if it received the stock from the Fehrses as a contribution to its capital; therefore, the petitioner's basis equals the basis of the transferred stock in the hands of Mr. and Mrs. Fehrs plus the amount of gain, if any, which was recognized by Mr. and Mrs. Fehrs upon the transfer.[3] Secs. 304(a)(1)

[3] It has been suggested that the transfer of Rental stock by Mr. and Mrs. Fehrs might be treated, in part, as a redemption and, in part, as a gift to the shareholders of the petitioner. The issue of whether the transfer was, in part, a gift is not before us, and we cannot decide it because no evidence as to the value of the Rental stock has been presented. Solely for the purposes of this opinion, we shall treat the entire transfer as a redemption.

(B) and 362(a)(2); sec. 1.304-2(a), Income Tax Regs. It has been stipulated that the basis of the transferred stock in the hands of the Fehrses was zero, so the only remaining question in computing the petitioner's basis in such stock is with respect to the amount of the gain, if any, which Mr. and Mrs. Fehrs recognized upon the transfer. According to the income tax regulations, there is no step-up in the petitioner's basis if the redemption is treated as essentially equivalent to a dividend under section 302 and if the payments to Mr. and Mrs. Fehrs are taxable as a dividend under sections 302(d) and 301, but if the redemption qualifies as an exchange under section 302(b), the petitioner's basis is increased by the gain recognized by Mr. and Mrs. Fehrs. Sec. 1.304-2(c), examples (1) and (3), Income Tax Regs. The validity of such rules has not been challenged. Thus, to determine whether there is any step-up in the petitioner's basis in the stock, it becomes necessary to determine first whether the redemption is essentially equivalent to a dividend under section 302 or whether it qualifies as an exchange under such section.

Section 302 sets forth in subsection (b) the conditions under which a redemption of stock shall be treated as an exchange, and provides in subsection (d) that if those conditions are not met, then the distribution is one to which section 301 applies. If the redemption meets any one of the four tests set forth in section 302(b), it is treated as an exchange, and the amount of the distribution is treated as payment for the stock. Neither party argues the applicability of Section 302(b)(2) or 302(b)(4) in this case, but the petitioner argues that the redemption should be treated as an exchange because it meets the test of either section 302(b)(1) or 302(b)(3). We shall consider each such test.

Section 302(b)(1) states, in effect, that the redemption shall be treated as an exchange if it "is not essentially

equivalent to a dividend." To meet this test, a redemption must result in a meaningful reduction of the shareholder's proportionate interest in the corporation, after applying the attribution rules of section 318(a) to the stock ownership interests as they existed both before and after the redemption. Secs. 1.302-1(a), 1.302-2(b), Income Tax Regs.; *United States* v. *Davis*, 397 U.S. 301 (1970). Furthermore, in answering the question of dividend equivalence, it is irrelevant that the transaction in issue had a bona fide business purpose other than tax avoidance. *United States* v. *Davis, supra; Johnson* v. *United States*, 434 F.2d 340 (C.A. 8, 1970); *Joseph Miele*, 56 T.C. 556, 567 (1971), on appeal (C.A. 3, Sept. 16, 1971); *Rose Ann Coates Trust, supra* at 514; *Ray A. Maher, supra* at 453.

After applying the attribution rules, Mr. and Mrs. Fehrs are considered as owning 98.2 percent of the outstanding shares of Rental—1,355 out of 1,380—both immediately before and immediately after the redemption by the petitioner. We discussed previously the method of computing the preredemption figure; the postredemption figure is reached by attributing to the Fehrses the shares owned by the petitioner as well as those owned by their descendants. The latter result obtains from attributing the petitioners' 1,159 shares to Mmes. Vleek and May by virtue of section 318(a)(2)(C), the 50-percent requirement of which is not applicable here by reason of section 304(b)(1), and then attributing those shares in turn to the Fehrses under section 318(a)(1)(A)(ii).

The respondent contends that the correct comparison of the Fehrses' stock ownership before and after the redemption is to measure the percentage of the shares owned by them *immediately* before and *immediately* after the redemption; if such contention is accurate, it is clear that the Fehrses' stock ownership (as viewed through the prism of

the attribution rules) was not changed at all by the redemption, and thus the redemption clearly fails to meet the test of section 302(b)(1) as articulated by the Supreme Court in *United States* v. *Davis, supra,* and as followed by this Court in the decisions previously cited.

On the other hand, the petitioner contends that the Fehrses' post-redemption stock ownership should be measured as of the end of the series of transactions—that is, after the transfer of the stock by the petitioner to Rental, and after the cancellation of such stock by Rental. Because the number of outstanding shares of Rental was substantially reduced by the cancellation, the percentage of shares attributable to the Fehrses was also reduced; the reduction was due to the fact that the 25 shares owned by Mr. Vleek (and consequently not attributable to the Fehrses) assumed a greater proportionate significance after the cancellation. However, even when measured in this way, the Fehrses are still considered to own 196 out of the 221 outstanding shares of Rental, or 88.69 percent of the total.

We need not pass upon the question of at which point in time the Fehrses' postredemption stock ownership should be measured, because we think that even if we adopt the view urged by the petitioner, and assume for the sake of argument that the redemption reduced the Fehrses' ownership interest from 98.2 percent to 88.69 percent, there still has not been "a *meaningful* reduction of the shareholder's proportionate interest in the corporation," as required by *United States* v. *Davis, supra* at 313. (Emphasis added.) A reduction in stock ownership from 98.2 to 88.69 percent does not deprive such a dominant shareholder of his ability to control the corporate activities; such a reduction does not affect the shareholder's relationship to the corporation in any significant way. See *Estate of William R. Runnels,* 54 T.C. 762, 766 (1970). Of course, the same percentage

spread might make a great deal of difference if the initial figure was not such a very high one, and there might be unusual circumstances in which the exact percentage reduction here would be material. Yet, in the present case, we have been shown no reason to believe that an 88.69-percent ownership interest in Rental would be less effective than a 98.2-percent interest. See *Friend* v. *United States*, 345 F. 2d 761, 764 (C.A. 1, 1965); *Bradbury* v. *Commissioner*, 298 F. 2d 111, 117 (C.A. 1, 1962). Moreover, the reduction that did occur resulted from a transfer of stock to the son-in-law of Mr. and Mrs. Fehrs, hardly a stranger to the family, and such transfer of ownership occurred because Mr. Fehrs made a gift of the stock to his son-in-law.

The petitioner advances other theories in support of its argument against dividend equivalence, but we do not find such theories to be helpful to its case. *Perry S. Lewis*, 47 T.C. 129 (1966), which was cited by the petitioner, was a case in which this Court held that payments made in exchange for a major shareholder's stock in a family-owned corporation were not essentially equivalent to a dividend. The majority opinion in *Lewis* stressed the existence of a business purpose for the redemption as an important factor in its decision; the petitioner argues the existence of a similar business purpose here, but such argument ignores the unambiguous language of the more recent Supreme Court opinion in the *United States* v. *Davis, supra*, to the effect that such a business purpose is irrelevant for the purpose of determining dividend equivalence. See also *Joseph Miele, supra; Rose Ann Coates Trust, supra; Ray A. Maher, supra.*

The petitioner argues that the *Davis* decision is distinguishable and not applicable in this case. It points out that in *Davis*, the redemption resulted in no reduction of Mr. Davis' constructive ownership, and that Mr. Davis was

in actual control both before and after the redemption; whereas in the present case, there may have been some slight change in Mr. Fehrs' constructive ownership, and Mr. Fehrs relinquished actual control. Despite these factual differences, we think that they lack legal significance. After reviewing the legislative history of section 302(b)(1), the Supreme Court concluded that Congress apparently had in mind a very limited purpose when it reinstated the dividend equivalency test in the 1954 Code; the Court pointed out that the provision was included to ease what would otherwise be the harsh result of section 302 " 'in the case of redemptions of preferred stock which might be called by the corporation without the shareholder having any control over when the redemption may take place.' " 397 U.S. at 310, citing S. Rept. No. 1622, to accompany H.R. 8300 (Pub. L. No. 591), 83d Cong., 2d Sess., p. 44 (1954); see also *John D. Gray*, 56 T.C. 1032, 1072 (1971). Here, Mr. Fehrs, like the petitioners in *John D. Gray*, was not the unwilling participant in the redemption, but was the guiding force behind it. The statements in an opinion must always be read with the facts of the case in mind. Yet, there is no indication that the Supreme Court intended for its opinion to be limited to the particular facts in the *Davis* case; on the contrary, its language is sweeping. The Court clearly holds that whenever the dividend equivalency test of section 302(b)(1) is to be applied, business purpose is irrelevant.

The petitioner also argues that the attribution rules should be considered only for the purpose of "determining the ownership of stock," as prescribed by section 302(c)(1), but not for the purpose of determining control as part of a dividend equivalency test under section 302(b)(1); thus, the petitioner argues, we should take cognizance of the alleged fact that the redemption "eliminated the actual control of Edward J. Fehrs over the affairs of Fehrs Rental

Co." However, in section 304, Congress expressly indicated that the attribution rules are to be applied in determining control. Section 304(a)(1) applies when one or more persons "control" each of two corporations; section 304(c)(1) defines control by stating that "control means the ownership" of stock possessing a specified percentage of voting rights or value; and section 304(c)(2) expressly provides, with one exception not here relevant, "Section 318(a) (relating to the constructive ownership of stock) shall apply for purposes of determining control under paragraph (1) [of section 304(c)]." The application of the attribution rules of section 318 to a redemption under section 304(a) can operate in such a way as to cause a person who actually owns no shares in a corporation to be treated as having 100-percent *control* of it. *Coyle* v. *United States*, 415 F. 2d 488, 490 (C.A. 4, 1968), reversing 268 F. Supp. 233 (S.D. W. Va. 1967). In *Coyle*, there is no indication that the taxpayer exercised actual control over the affairs of such corporation; the Fourth Circuit regarded the attribution rules alone as sufficient to impute complete control to him. This Court, too, has applied the attribution rules to determine who controlled a corporation involved in a redemption under section 304. *Ralph L. Humphrey, supra* at 205. See also Ringel, Surrey, & Warren, "Attribution of Stock Ownership in the Internal Revenue Code," 72 Harv. L. Rev. 209 (1958), in which the authors state in a context of discussing section 304. "The stock-attribution rules of section 318 apply to the determination of whether control exists * * *." 72 Harv. L. Rev. 226-227.

Similarly, it appears that when Congress provided that the attribution rules of section 318(a) are to be applied in determining the constructive ownership of stock for the purposes of section 302, it intended that a person who is deemed to be the constructive owner of the stock under such

rules should be treated in all material respects as the actual owner of the stock, and as the possessor of all the usual incidents of ownership. See H. Rept. No. 1337, to accompany H.R. 8300 (Pub. L. No. 591), 83d Cong., 2d Sess., p. 36 (1954). Probably the ability to control the corporation and guide its activities is the single most significant element of stock ownership in the case of an approximately 90-percent interest in a closely held family corporation which does not regularly, if ever, pay dividends. We can perceive no reason why Congress would provide that Mr. Fehrs should be treated as the owner of such a substantial percentage of the stock of Rental unless he was also to be treated as being in a position to exercise the degree of control over such corporation as the owner of such a block of stock would ordinarily possess, and there is no authority to support such anomalous treatment. Indeed, in *United States* v. *Davis, supra,* in which dividend equivalence was the chief issue, the Supreme Court said of a taxpayer who actually owned only 250 out of the 1,000 shares of the outstanding stock of a corporation in which his wife and children owned the remaining stock, "After application of the stock ownership attribution rules, this case viewed most simply involves a sole stockholder who causes part of his shares to be redeemed by the corporation" 397 U.S. at 307. We think that the Supreme Court would not have applied the appellation "sole stockholder," with all of its connotations, to the taxpayer in *Davis* if it believed that he might not properly be regarded as controlling the shares attributed to him. Thus, insofar as it is relevant in determining the question of dividend equivalence in this case, we conclude that the attribution rules require that Mr. Fehrs must be treated as continuing in actual control of Rental after the transaction here in issue. *Levin* v. *Commissioner,* 385 F. 2d 521, 525 (C.A. 2, 1967), affirming 47 T.C. 258 (1966). We hold that

the redemption cannot be treated as an exchange under section 302(b)(1).

The next question is whether section 302(b)(3) is applicable. Such section provides that the redemption is to be treated as an exchange "if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder." However, under section 302(c)(1), the attribution rules of section 318 are applicable in determining whether a redemption has resulted in the complete termination of a shareholder's interest under section 302(b)(3), but section 302(c)(2) sets forth certain conditions under which the attribution rules are not applicable for such purposes. Obviously, Mr. and Mrs. Fehrs did actually transfer all of their stock in Rental, but whether the redemption can qualify under section 302(b)(3) depends upon whether the conditions of section 302(c)(2) have been met so that the attribution rules are not applicable.

Section 302(c)(2)(A) provides that, if all of three conditions specified in the statute are met, then the attribution rules are inapplicable with respect to a redemption which actually terminated the shareholder's interest within the meaning of section 302(b)(3). The three conditions are:

> (i) immediately after the distribution the distributee has no interest in the corporation (including an interest as officer, director, or employee), other than an interest as a creditor,
>
> (ii) the distributee does not acquire any such interest (other than stock acquired by bequest or inheritance) within 10 years from the date of such distribution, and
>
> (iii) the distributee, at such time and in such manner as the Secretary or his delegate by regulations prescribes, files an agreement to notify the Secretary or his delegate of any acquisition described in clause (ii)

> and to retain such records as may be necessary for the application of this paragraph.

Section 302(c)(2)(A) further provides that if the distributee acquires an interest other than that of a creditor, and other than an interest obtained by bequest or inheritance, in the corporation within 10 years from the date of the distribution, then the statute of limitations with respect to the assessment and collection of the tax due as a result of such acquisition of interest shall not expire until 1 year after the distributee notifies "the Secretary or his delegate" of such acquisition in conformity with the appropriate regulations.

With respect to the agreement described in section 302(c)(2)(A)(iii), the requirements are set out in greater detail in section 1.302—4(a), Income Tax Regs.; in part, such regulations provide:

> (a) The agreement specified in section 302(c)(2)(A)(iii) shall be in the form of a separate statement in duplicate signed by the distributee and attached to his return timely filed for the year in which the distribution described in section 302(b)(3) occurs.* * *

Mr. and Mrs. Fehrs did not file such an agreement with their income tax return for 1965, nor have they filed or attempted to file any such agreement since that time. Indeed, the petitioner admits the Fehrses' omission in this respect, but it argues that such omission should not serve to prevent the application of section 302(c)(2)(A). In making that argument, the petitioner relies on *Georgie S. Cary,* 41 T.C. 214 (1963) and cites also *Pearce* v. *United States,* 226 F. Supp. 702 (W.D. N.Y. 1964); and *Van Keppel* v. *United States,* 206 F. Supp. 42 (D. Kan. 1962), affd. 321 F. 2d 717 (C.A. 10, 1963).

In *Georgie S. Cary, supra,* all of the taxpayer's stock in a corporation was redeemed, but the remainder of the stock continued to be owned by her son. The taxpayer failed to

attach the agreement required by section 302(c)(2)(A)(iii) to her Federal income tax return for the year of the redemption, but after the respondent commenced an audit of her return, she promptly filed an amended return for the year of the redemption, with the agreement attached. We held that the statutory provision pertaining to the filing of the agreement requires only substantial compliance, rather than strict compliance, and that substantial compliance was effected under the facts of that case. Similarly, the taxpayers in *Pearce* v. *United States, supra,* and *Van Keppel* v. *United States, supra,* each substantially complied with the requirement of section 302(c)(2)(A)(iii) by filing (or attempting to file) the agreement upon discovering the inadvertent failure to do so earlier.

However, the facts of this case are significantly different from those in *Cary* and the other two cases. In the interest of justice, we concluded in *Cary* that substantial compliance was enough because it was sufficient to accomplish the legislative objective for requiring the agreement. To hold, as the petitioner urges, that section 302(c)(2)(A) is applicable even though an agreement has not been filed at any time would nullify the clear statutory provision requiring one to be filed. Congress considered that to carry out its legislative plan, an agreement must be filed by a shareholder whose stock is redeemed when the remaining stock is still owned by related parties. See S. Rept. No. 1622, *supra* at p. 236. We cannot ignore the express provisions of the statute. Accordingly, we hold that since the agreement required by section 302(c)(2)(A)(iii) has not been filed by Mr. and Mrs. Fehrs, the attribution rules of section 318 are applicable, and the redemption of their stock does not qualify as an exchange under section 302(b)(3).

For the foregoing reasons, the redemption in which the petitioner acquired the Rental stock from Mr. and Mrs.

Fehrs does not qualify for treatment as an exchange under any of the provisions of section 302(b), and therefore, under section 302(d), the redemption shall be treated as a distribution of property governed by section 301.

Section 301(c)(1) provides in effect that, to the extent that it is made out of the corporation's earnings and profits, the distribution is treated as a dividend and is taxed as ordinary income to the recipient. Section 301(c)(2) goes on to provide that, to the extent that the distribution is not a dividend, it is first applied against the recipient's adjusted basis in the stock, and then, according to section 301(c)(3), the amount which exceeds such adjusted basis is treated as gain from the sale or exchange of property. The petitioner argues that, because it had no earnings and profits during its 1965 taxable year, the tax consequences to Mr. and Mrs. Fehrs of the annuity payments are governed by section 301(c)(2) and (3) and that the petitioner's basis in the stock acquired in the redemption should include, for purposes of computing its gain on the sale of the stock in 1965, the gains to be recognized in subsequent years by Mr. and Mrs. Fehrs as a result of the receipt of the annuity payments.

Initially, the respondent contends that there should be no increase in the petitioner's basis by reason of any gain recognized by the Fehrses under section 301. The respondent argues that section 362(a) provides for an increase in basis by reason of a gain recognized on the transfer and that such language does not apply to gains recognized under section 301(c)(3). There is nothing in the statute or the legislative history to support such contention. The words of section 362(a) are clearly broad enough to apply to a gain recognized under section 301(c)(3), and accordingly, we reject such contention of the respondent.

The petitioner's argument that the annuity payments to Mr. and Mrs. Fehrs will be taxable, after recovery of basis, as a gain under section 301(c)(3) rests on the propositions that it had no earnings and profits in its 1965 taxable year and that the tax treatment of the payments that Mr. and Mrs. Fehrs will receive in later years is determined by its earnings and profits, or lack thereof, in 1965. The petitioner showed no earnings and profits in its books and records for 1965, but the respondent contends that its computations were incorrect for the reason that it recognized a gain on the sale of the Rental stock in that year and that such gain was erroneously omitted from its computation of earnings and profits. However, we would be required to determine the amount of the petitioner's earnings and profits in 1965 only if we conclude that the amount of, or the lack of, such earnings and profits governs the tax treatment of the property distributed to Mr. and Mrs. Fehrs. Thus, we must first decide what constituted the property distributed to the Fehrses, when the distribution or distributions occurred, and for what year or years the earnings and profits of the petitioner are determinative of the tax treatment of such property.

The petitioner argues that the making of the annuity contracts in 1965 constituted distributions of property under section 301, but we do not agree. The annuity agreements were simply promises to make payments to the Fehrses at a later time, contingent, of course, upon their surviving. The agreements provided unequivocally that they, and the payments to be made under them, could not be negotiated, assigned, or anticipated by the Fehrses, and that if the Fehrses did purport to make any such negotiation, assignment, or anticipation, the petitioner would be in no way obliged to recognize or give effect to it. Moreover, the petitioner, which was the obligor under the annuity agreements,

was a new corporation with no substantial assets and no history indicating its financial reliability; the Fehrses' right to receive payments was no better secured than if the obligor were a private individual. Whatever the Fehrses may have considered the agreements to be worth to them, the agreements were in no way the equivalent of cash. Unlike the recipient of an ordinary promise to make a payment at a certain time in the future, the Fehrses did not receive anything in 1965 which they could have disposed of even at a substantial discount.

Leaving aside the question of the petitioner's ability to make the payments as they come due, it is true that a so-called actuarial value could be computed for the annuity agreements, but such value could not be realized by the Fehrses in 1965. No amount was recognizable by them in that year as a result of the receipt of the annuity agreements. *Commissioner* v. *Kann's Estate*, 174 F. 2d 357, 359 (C.A. 3, 1949), affirming a Memorandum Opinion of this Court; *Frank C. Deering*, 40 B.T.A. 984, 985—987 (1939); *J. Darsie Lloyd*, 33 B.T.A. 903, 905 (1936); *Hill's Estate* v. *Maloney*, 58 F. Supp. 164, 172 (D. N.J. 1944); see also *Glenn E. Edgar*, 56 T.C. 717, 742 fn. 15 (1971). The annuity agreements are similar in certain significant respects to the contract involved in *Allan S. Vinnell*, 52 T.C. 934 (1969), in which we held that the making of the contract did not constitute a distribution of property because of its contingent nature, so that the payment of each sum due under the contract constituted a separate distribution. In *Vinnell*, the shareholder's rights to the payments were subject to certain business contingencies, and his rights were expressly subordinated to the claims of a bank with which the corporation dealt. The occurrence of one of the contingencies would have resulted in the deferral or postponement or subordination of the payments, but in the present case, the

occurrence of one certain contingency—the death of Mr. or Mrs. Fehrs—would terminate the obligation completely. Moreover, the corporate obligor in *Vinnell* had proven its viability as a business entity over a 14-year period, whereas the fledgling nature of the present petitioner created an additional contingency to undermine the certainty of the Fehrses' receiving the payments in the future. In *Thomas Kerr*, 38 T.C. 723 (1962), affd. 326 F. 2d 225 (C.A. 9, 1964), certiorari denied 377 U.S. 963 (1964); and *Rose Ann Coates Trust*, 55 T.C. 501 (1970), on appeal (C.A. 9, June 17, 1971), we held that the distribution of a corporate obligation constituted a distribution of property; but in those cases, the obligations were to pay fixed amounts over fixed periods of time, and those obligations had ascertainable fair market values. Thus, in this case, we reach the conclusion that no property distribution within the meaning of sections 301 and 317 was made in 1965.

Another argument advanced by the petitioner is that even if no distribution was made in 1965, the tax character of the annuity payments distributed in later years must be governed by the amount of the petitioner's earnings and profits—or the lack thereof—in the year 1965. The petitioner asserts that such argument is supported by *Samuel Goldwyn*, 9 T.C. 510 (1947), affd. 175 F. 2d 641 (C.A. 9, 1949). In *Goldwyn*, the corporation declared a dividend in fiscal 1931, and provided that such dividend should be payable on a certain date in that year. At the time of the declaration, the corporation debited (reduced) its surplus account by the amount of the dividend, with the book entries indicating the amount which represented each shareholder's proportionate share of the dividend. At the time the dividend was declared, no cash payments were actually made to the shareholders in fiscal 1931 on account of the dividends declared. Such dividends were treated as a lia-

bility on the corporate books from the time of declaration. However, in fiscal 1933, the shareholders instructed the corporation to credit the amount of the dividend payable to each of them against amounts they owed the corporation, and the corporation did so, thus eliminating the dividends payable liability. Apparently, the shareholders reported the dividends as income for 1933.

The question presented to the Court in *Goldwyn* was whether the corporate actions in fiscal 1931 brought about a reduction of earnings and profits in that year. The Court held that the corporation had indeed reduced its earnings and profits in fiscal 1931, when it set aside a portion of its surplus to create a fixed liability to the shareholders. Such conclusion was reached without regard to the year in which the shareholders should have reported the dividends as income, but the Court added, as a second basis for its conclusion, that it was convinced that the shareholders had in fact constructively received the dividends in fiscal 1931, because the shareholders acquired in that year the ability to control completely the funds set aside for their benefit. The Ninth Circuit affirmed the decision of this Court on the ground that the amount of the corporate surplus was reduced in fiscal 1931, without considering the question of whether the shareholders constructively received the dividends in that year.

Even without regard to the constructive-receipt aspect of *Goldwyn*, we think that the case is factually distinguishable. In fiscal 1931, the corporation in *Goldwyn* undertook to segregate a portion of its earnings and profits as of that time; it actually set aside a specified amount out of its surplus on hand and created a fixed liability in such amount to the shareholders, with each shareholder's portion being designated. The shareholders' rights in their respective portions were such that two of the shareholders assigned part

of their interests to another shareholder, and the corporation apparently gave full effect and recognition to such assignment. On the contrary, the petitioner here, when it entered into the annuity agreements, did not undertake to distribute earnings and profits as of 1965; it had no earnings and profits, current or accumulated, at the time of the making of the agreements. In fact, the petitioner did not set aside any specific presently existing sum of money, from whatsoever source, for the purpose of dedicating such sum to the satisfaction of the obligation to the Fehrses. Unlike the corporation in *Goldwyn*, when the petitioner in this case recorded the annuity obligation as a liability on its books, it was simply recognizing its promise to make payments in the future.

In *Goldwyn*, we held that when a corporation takes the steps which the corporation in that case took to create a liability to pay dividends to its shareholders, and to dedicate a portion of its presently existing earnings and profits to the satisfaction of such liability, the actual distributions to the shareholders, whenever made, are considered to be made out of the earnings and profits which were dedicated to that purpose. From such holding, it does not follow that if a corporation, when it lacks earnings and profits, becomes obliged to make distributions to shareholders (which Mr. and Mrs. Fehrs are treated as for this purpose) in future years, such distributions will be treated as if made when the corporation had no earnings and profits. The purposes of sections 301 and 316 would surely be violated if we were to hold that distributions made by a corporation to its shareholders out of earnings and profits could be treated as recoveries of basis or capital gains to the shareholders simply because the payments were made pursuant to the terms of an agreement entered into by the corporation in an earlier year when it had no earnings and profits. Accordingly, we reject the petitioner's argument that the tax

treatment of the annuity payments which Mr. and Mrs. Fehrs receive in subsequent years is determined by the petitioner's apparent lack of earnings and profits in 1965. The taxability of such annuity payments will depend upon the circumstances existing in such later years.

Since no annuity payments were made to Mr. and Mrs. Fehrs in 1965, and since we have concluded that the making of the annuity contracts did not constitute a distribution of property to them in that year, no amount of gain was recognized by them in 1965 as a result of the transfer of their stock to the petitioner. The petitioner argues that its basis should include the amount of gains to be recognized by Mr. and Mrs. Fehrs in subsequent years. Although there may be circumstances in which the acquiring corporation's basis in property should take into consideration the gains to be recognized by the transferors in later years—a question which we need not and do not decide—it seems clear that such a prediction of future gains could be appropriate only when there is a reasonably reliable method for ascertaining the amount of such gains. Here, it is utterly impossible to anticipate the amount of gains to be recognized in the future. By use of actuarial tables, the amounts of the annuity payments that Mr. and Mrs. Fehrs will receive, if they live out their life expectancies, can be estimated, but it is impossible to forecast whether such payments will be treated as dividends under section 301(c)(1) or as gains under section 301(c)(3). According to its books and records, the petitioner showed substantial deficits for the years 1966, 1967, and 1968, but the respondent has raised several serious objections to the petitioner's method of computing its earnings and profits for those years. Irrespective of who is right as to those years, there is no certainty that the petitioner will operate at a loss in subsequent years during the lifetimes of Mr. and Mrs. Fehrs. In any year in which it

earns profits, the payments to Mr. and Mrs. Fehrs would probably be considered as dividends under section 301(c)(1). In view of this uncertainty, there is no satisfactory method of anticipating the amounts that will be recognized as gains under section 301(c)(3) by Mr. and Mrs. Fehrs. Thus, we conclude that the petitioner's basis in 1965 must be limited to any gain recognized by the transferors in that year; that is, zero. It will be necessary to postpone to 1966 and subsequent years any adjustment in the petitioner's basis in the Rental stock to reflect any gains recognized under section 301(c)(3) by Mr. and Mrs. Fehrs. Accordingly, we hold that in 1965, the petitioner's basis for the purpose of computing its gain on the sale of the Rental stock must be zero, and it must recognize as a gain the entire payment which it received in that year.

In seeking the answers to the questions in this case, we searched the legislative history of section 304. The Advisory Group, created by the Ways and Means Committee to study the provisions of subchapter C of the Code (secs. 301 *et seq.*) and make recommendations with respect to such provisions, was of the opinion that the provisions as enacted do not carry out the purpose of the section, and the Advisory Group recognized the need for statutory changes. Revised Report of the Advisory Group on Subchapter C to the Committee on Ways and Means, p. 12 (Dec. 11, 1958). See also Supplemental Statement of the American Bar Association, Section of Taxation, filed with the Senate Finance Committee in connection with hearings on H.R. 8300 (Pub. L. No. 591), 83d Cong., 2d Sess., p. 343, 353 (1954); First Report on H.R. 8300 of the Association of the Bar of the City of New York, Committee on Taxation, *ibid* at 504, 520; Statement on behalf of Empire State Chamber of Commerce, Albany, N.Y., with respect to H.R. 8300 *ibid* at 2075, 2080. The changes recommended by the Advisory Group have not been made, and we must interpret the statute as

it was enacted and remained in effect for the years in issue in this case. Here, we do not have statutory provisions that are general and ambiguous as to how they are to be applied to the particular facts of the case before us. Compare *International Trading Co.*, 57 T.C. 455 (1971). Here, the statutory provisions are specific and set forth clearly the legislative purpose. Under these circumstances, there is no doubt as to what was intended by the Congress, and we have applied those provisions as intended. If the results do not carry out the underlying purposes of section 304, as suggested by the Advisory Group, it will then be necessary for the Congress to take up the matter and make any changes in the statute which it considers appropriate.

To reflect the respondent's concession that the petitioner's gain in 1965 should be treated as long-term capital gain.

Decision will be entered under Rule 50.

Reviewed by the Court.

TANNENWALD, *J.*, concurring: I fully agree with Judge Simpson's comprehensive analysis and append these additional comments only for the purpose of making clear the precise scope of our decision.

First, this case concerns the basis provisions of section 362(a)(2). Its rationale may not be equally applicable, in other circumstances, to the determination of basis of property acquired in exchange of an annuity.[1] See *John C. W. Dix*, 46 T.C. 796 (1966), affirmed on other issues 392 F. 2d 313 (C.A. 4, 1968); Rev. Rul. 69-74, 1969-1 C.B. 43; Rev. Rul. 55-119, 1955-1 C.B. 352. See also *Peter Vaira*, 52 T.C. 986,

[1] We note that the general provision stating that "The basis of property shall be the cost of such property" specifically excepts from its operation the provisions of subch. C, which includes sec. 362. See sec. 1012.

996-998 (1969), remanded on other grounds 444 F.2d 770 (C.A. 3, 1971).

Second, our opinion should in no way be taken as an expression of our views as to whether, in another context, e.g., the taxability of transferor shareholders, we would not, under the circumstances herein, look through the initial acquisition and treat the transaction as in substance a redemption by the corporation whose stock was acquired and simultaneously redeemed. Cf. *Gregory* v. *Helvering*, 293 U.S. 465 (1935).

DRENNEN, RAUM, and IRWIN, *JJ.*, agree with this concurring opinion.

QUEALY, *J.*, concurring: I am compelled to concur in this decision because of the manner in which the issues were presented. However, as pointed out by Judge Tannenwald in his concurring opinion, there is serious question whether the Court should not look to the real nature of the transaction. What we may really have here is a sale of stock by Mr. Fehrs to his various relatives, the consideration to be paid out of the future earnings of the corporation. See *Casner* v. *Commissioner*, 450 F. 2d 379 (C.A. 5, 1971).

DRENNEN, *J.*, agrees with this concurring opinion.

COURT OF APPEALS OPINION

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

No. 72-1638

No. 73-1068

Fehrs Finance Company,
Appellant,
Cross-Appellee,

vs.

Commissioner of Internal Revenue,
Appellee,
Cross-Appellant.

Appeal from Decision of the United States Tax Court

Submitted: September 10, 1973

Filed: November 6, 1973

Before HEANEY, STEPHENSON and WEBSTER, Circuit Judges.

STEPHENSON, Circuit Judge.

The focal point of this controversy concerns the basis attributable to certain stock in the hands of the acquiring corporation in connection with a redemption of stock

through the use of related corporations pursuant to 26 USC §§ 304(a) and 362(a)(2).

Our task is to review the decision of the United States Tax Court[1] wherein, after an extensive examination of the facts and the several sub-issues, the court determined that the basis of the stock in question was zero since the transferors had recognized no gain on the transfer for the tax year in question.

We affirm the Tax Court in all respects and set out only those facts that become necessary to a determination and explanation of the issues.

The transaction which began this case is not complex. Mr. and Mrs. Fehrs owned all of the stock of Fehrs Rental Corporation (Rental). Mr. Fehrs gave a small portion of his stock to his wife, son-in-law, daughters and grandchildren. Approximately two months thereafter Fehrs Finance Company (Finance) was newly incorporated with two of the Fehrs' daughters as sole shareholders. Mr. and Mrs. Fehrs then transferred all of the remaining Rental stock to Finance in return for Finance's promise to pay to the Fehrs annuities totaling $70,000 per year for their lives. Finance immediately resold the Rental stock to Rental in exchange for $100,000 in cash and an unsecured promissory note in the sum of $625,000.

The Tax Court held that Finance realized a taxable gain of $100,000 in 1965 (the cash received in 1965) since its basis was zero.[2] The parties stipulated that the basis of the stock in the hands of Mr. and Mrs. Fehrs was zero. Finance (taxpayer) contends that Mr. and Mrs. Fehrs real-

[1] The Tax Court opinion is reported at 58 T.C. 174 (1972). Our jurisdiction is conferred by 26 USC § 7482(a).

[2] An increased basis for gift taxes paid by Mr. and Mrs. Fehrs was allowed by the Tax Court. The same will be later discussed.

ized a capital gain on the transfer which, in turn, increased the basis of the stock in the hands of taxpayer, Finance. The Tax Court disagreed. We agree with the Tax Court.

The parties do not quarrel with the Tax Court's characterization of the foregoing transaction as a redemption through the use of related corporations. 26 USC § 304(a).

According to § 304[3] the acquiring corporation (Finance) must treat the stock acquired as a contribution to its capital.

When the stock in question has been treated as a contribution to capital, the basis of that stock in the hands of the transferee (Finance) is the same as it would be in the hands of the transferor (the Fehrs), increased by the amount of gain recognized to the transferor on the transfer.[4]

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[3] Sec. 304. REDEMPTION THROUGH USE OF RELATED CORPORATIONS

(a) *Treatment of Certain Stock Purchases.*—

(1) *Acquisition by related corporation (other than subsidiary).*—For purposes of Sections 302 and 303, if—

(A) one or more persons are in control of each of two corporations, and

(B) in return for property, one of the corporations acquires stock in the other corporation from the person (or persons) so in control,

then (unless paragraph (2) applies) such property shall be treated as a distribution in redemption of the stock of the corporation acquiring such stock. In any such case, the stock so acquired shall be treated as having been transferred by the person from whom acquired, and as having been received by the corporation acquiring it, as a contribution to the capital of such corporation.

• • •

[4] Section 362(a) states:

(a) *Property Acquired by issuance of Stock or as paid-in surplus.*—If property was acquired on or after June 22, 1954, by a corporation—

(1) in connection with a transaction to which section 351 (relating to transfer of property to corporation controlled by transferor) applies, or

(2) as paid-in surplus or as a contribution to capital, then the basis shall be the same as it would be in the

It becomes necessary due to the interworkings of sections 304 and 362 of the Internal Revenue Code to determine whether or not the Fehrs realized any gain on the redemption. If they did not, the basis of the Rental stock in the hands of Finance would be zero; i.e., the substituted basis of Mr. and Mrs. Fehrs.[5] If they realized a gain, the basis of the Rental stock to Finance would be increased by the amount of that gain. Hence, Finance's gain on resale would be less.

Only gain realized by the Fehrs on a sale or exchange (capital gain) will allow Finance to receive the "stepped-up" basis for which it argues. If the transaction gave rise to dividend or ordinary income to the Fehrs it would not affect Finance's basis.

Finance advances two theories, either of which it says will support the assertion that the transaction was an exchange giving rise to capital gain to the Fehrs, and therefore increasing Finance's basis in the stock. The two theories are found in 26 USC § 302(b)(1) and (3)[6] and will be discussed separately.

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hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer.

(b) *Transfers to corporations.*—If property was acquired by a corporation in connection with a reorganization to which this part applies, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer. This subsection shall not apply if the property acquired consists of stock or securities in a corporation a party to the reorganization, unless acquired by the exchange of stock or securities of the transferee (or of a corporation which is in control of the transferee) as the consideration in whole or in part for the transfer.

[5] The basis of the Rental stock in the hands of Mr. and Mrs. Fehrs was stipulated to be zero.

[6] Section 302 in relevant part states:

(a) *General Rule.*—If a corporation redeems its stock (within the meaning of section 317(b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall

I.

Dividend Equivalency

The essence of 302(b)(1) is that a redemption will be treated as an exchange if it "is not essentially equivalent to a dividend." Paramount to the dividend equivalency test are several preliminary rules which we must consider.

To qualify for the preferred treatment of 302(b)(1) the redemption "must result in a meaningful reduction of the shareholder's proportionate interest in the corporation." *United States* v. *Davis*, 397 U.S. 301, 313 (1970). It is settled that the attribution rules of section 318(a)[7] apply to the stock ownership interest when 302(b)(1) dividend equivalency is in question. *Davis, supra* at 305-307.

Determination as to whether or not the redemption had a "business purpose" is no longer a relevant inquiry regarding dividend equivalency under 302(b)(1). *Davis, supra* at 312; *Johnson* v. *United States*, 434 F.2d 340, 343 (CA8 1970); *Wright* v. *United States*, 482 F.2d 600, 608-609 (CA8 1973).

The Tax Court recognized the above guidelines and concluded:

> Thus, insofar as it is relevant in determining the question of dividend equivalence in this case, we conclude

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be treated as a distribution in part or full payment in exchange for the stock.

(b) *Redemptions Treated as Exchanges.*—

(1) *Redemptions not equivalent to dividends.*—Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.

• • •

(3) *Termination of shareholder's interest.*—Subsection (a) shall apply if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder.

[7] Under section 318 an individual is considered as owning stock held by his spouse, parent, child, or grandchild.

> that the attribution rules require that Mr. Fehrs must be treated as continuing in actual control of Rental after the transaction here in issue. (citation omitted) We hold that the redemption cannot be treated as an exchange under section 302(b)(1). 58 T.C. at 188.

We agree. The judgment as to whether a redemption is "not essentially equivalent to a dividend" turns on the facts of each case. *Wright, supra* at 606. Viewing this case in the setting which the attribution rules dictate, the only stock which is not constructively owned by the Fehrs is the fifteen shares given by Mr. Fehrs to his son-in-law. See 58 T.C. at 176. Even after the resale of the Rental stock back to Rental, and the subsequent cancellation of that stock diminishing the Fehrs ownership interest from 98.2 to 88.69 percent, the proportionate interest of these stockholders in this corporation was not meaningfully reduced. *Davis, supra* at 313. It is not necessary for us to determine whether the Fehrs post-redemption ownership must be measured before or after cancellation of the stock. We agree with the Tax Court that even if we "assume for the sake of argument that the redemption reduced the Fehrses' ownership interest from 98.2 percent to 88.69 percent" the mandates of *Davis* would not be fulfilled. We are not convinced that the Tax Court findings are against the clear weight of evidence or induced by an erroneous view of the law. *Commissioner of Int. Rev.* v. *Ironsport Mfg. and Equip. Co.*, 478 F.2d 731, 734 (CA8 1973); *Riss* v. *Commissioner of Int. Rev.*, 478 F.2d 1160, 1164 (CA8 1973).

Complete Redemption

Finance strongly urges that this redemption qualifies as an exchange since there was a "complete redemption of all of the stock of the corporation owned by the shareholder." 26 USC § 302(b)(3). If Finance is to be successful on this point it must show that the provisions of 302(c)(2)(A)[8]

have been fulfilled. That section frees a taxpayer from the application of the attribution rules to its redemption provided the three tests are fulfilled.

There is no question that the Fehrs themselves no longer own any Rental stock. Nevertheless, they constructively own those shares owned by their daughters and grandchildren.

Finance asserts that the Fehrs are protected from that constructive ownership in this instance because they have fully complied with the 302(c)(2)(A) criteria.

This appeal concerns only the third proviso of 302(c)(2)(A), which obligates the taxpayer to file an agreement with the Internal Revenue Service. Thereunder the taxpayer promises to notify the IRS of any re-acquisition (other than by bequest or inheritance) of stock in the corporation within ten years after the distribution.[9]

The corresponding regulation is Treas. Reg. 1.302-4 § (1973) providing:

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[8] That section provides:

> (c) *Constructive Ownership of stock.*—
>
> (2) *For determining termination of interest.*—
>
> (A) In the case of a distribution described in subsection (b)(3), section 318(a)(1) shall not apply if—
>
> (i) immediately after the distribution the distributee has no interest in the corporation (including an interest as officer, director, or employee), other than an interest as a creditor,
>
> (ii) the distributee does not acquire any such interest (other than stock acquired by bequest or inheritance) within 10 years from the date of such distribution, and
>
> (iii) the distributee, at such time and in such manner as the Secretary or his delegate by regulations prescribes, files an agreement to notify the Secretary or his delegate of any acquisition described in clause (ii) and to retain such records as may be necessary for the application of this paragraph.

[9] *Id.*

Section 302(b)(3) provides that a distribution in redemption of all of the stock of the corporation owned by a shareholder shall be treated as a distribution in part or full payment in exchange for the stock of such shareholder. In determining whether all of the stock of the shareholder has been redeemed, the general rule of section 302(c)(1) requires that the rules of constructive ownership provided in section 318(a) shall apply. Section 302(c)(2), however, provides that section 318(a)(1) (relating to constructive ownership of stock owned by members of a family) shall not apply where the specific requirements of section 302(c)(2) are met. The following rules shall be applicable in determining whether the specific requirements of section 302(c)(2) are met:

(a) The agreement specified in section 302 (c)(2)(A)(iii) shall be in the form of a separate statement in duplicate signed by the distributee and attached to his return timely filed for the year in which the distribution described in section 302(b)(3) occurs. The agreement shall recite that the distributee has not acquired any interest in the corporation (as described in section 302(c)(2)(A)(i)) since such distribution, and that he agrees to notify the district director of internal revenue for the district in which such return is filed of any acquisition of such an interest in the corporation within 30 days after such acquisition if such acquisition occurs within 10 years from the date of such distribution.

• • •

When this case was decided the Fehrs had not yet filed the required agreement. Not surprisingly, therefore, the Tax Court held that the mandates of the Code has not been met. Immediately following the Tax Court decision the Fehrs filed the agreement with the Omaha IRS office. Finance now asserts that this belated filing should be deemed by us to be sufficient.

We have carefully considered the cases relied upon by Finance which hold that only "substantial compliance" with 302(c)(2)(A) is required. *Cary* v. *Commissioner*, 41

T.C. 214 (1963); *U.S.* v. *Van Keppel*, 321 F.2d 717 (CA10 1963); *Pearce* v. *U.S.*, 226 F.Supp. 702 (W.D.N.Y. 1964). *But see, Archbold* v. *United States*, 201 F.Supp. 329 (D.N.J. 1962), *affirmed per curiam* 311 F.2d 228 (CA3 1963). We have no disagreement with those cases wherein taxpayers were allowed to file tardy agreements before the law suits were tried. While it is not our function to reconcile other decisions of the Tax Court, *Jantzer* v. *C.I.R.*, 284 F.2d 348, 355 (CA9 1960), we find the instant case clearly distinguishable.

The agreement in this case was not filed until after the Tax Court decision declaring that the Fehrs had not complied with the statute.[10] Finance made no request upon the Tax Court to reconsider its opinion in light of the belated filing.

We are not at liberty to digress from the provisions of the governing statutes merely because a case may present hard facts. *Fearing* v. *C.I.R.*, 315 F.2d 495, 499 (CA8 1963) (Blackmun, J.). We hold that in this case the filing of the statutory agreement, over six years after the returns were due and only after an adverse decision in the Tax Court, does not substantially comply with section 302(c)(2)(A) of the Internal Revenue Code.

II.

Having determined the Fehrs' redemption scheme does not qualify for treatment as an exchange pursuant to 302(b) we must view it as a distribution of property governed by

[10] The present posture of this issue in the case presents some question as to whether this court should consider an issue not squarely faced by the Tax Court. *Joslin* v. *C.I.R.*, 424 F.2d 1223, 1227 (CA7 1970). Our consideration is warranted since no new or more expansive factual determinations need be made. *Estate of Bird* v. *C.I.R.*, 388 F.2d 223, 233-234 (CA5 1967); *Frederick Steel Co.* v. *C.I.R.*, 375 F.2d 351, 355 (CA6 1967).

section 301. 26 USC § 302(d). The Tax Court properly set out the application of section 301:

> Section 301(c)(1) provides in effect that, to the extent that it is made out of the corporation's earnings and profits, the distribution is treated as a dividend and is taxed as ordinary income to the recipient. Section 301(c)(2) goes on to provide that, to the extent that the distribution is not a dividend, it is first applied against the recipient's adjusted basis in the stock, and then, according to section 301(c)(3), the amount which exceeds such adjusted basis is treated as gain from the sale or exchange of property. 58 T.C. at 190.

The Tax Court went on to hold:

(1) The mere forming of the annuity contracts between Finance and the Fehrs in 1965 did not constitute a "distribution of property" for 301 purposes in 1965.

(2) Since the Fehrs received no payments under the annuity contracts in 1965 no property distributions were in fact made within the meaning of 301 for the 1965 tax year.

(3) Since no distribution of property was made to the Fehrs in 1965 they realized no capital gain under 301(c)(3)(A) which could, in turn, be attributed to Finance as a stepped-up basis in the Rental stock. 58 T.C. 174, 191-194.

On the basis of the well reasoned Tax Court opinion, we affirm the determination that no property distribution within the meaning of sections 301 and 317[11] was made in 1965.

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[11] § 317. (a) *Property.*—For purposes of this part, the term "property" means money, securities, and any other property; except that such term does not include stock in the corporation making the distribution (or rights to acquire such stock).

(b) *Redemption of stock.*—For purposes of this part, stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock.

Finance urges that the recent case of *Estate of Lloyd G. Bell*, ¶ 60.52 P-H T.C. 287 (June 26, 1973) requires a contrary result.

Bell involved a sale of stock in exchange for a private annuity. The Tax Court held that gain should have been recognized by the transferor of the stock in the year of the sale. The measure of gain was determined to be the difference between the adjusted basis of the stock and the actuarial value of the annuity contract. Finance suggests that same philosophy should be applied here and that its basis in the Rental stock should be $552,373.84, that is, the amount of gain properly recognized by the Fehrs under the *Bell* opinion. We do not agree.

We recognize several of the same characteristic distinguishing factors in *Bell* which the Tax Court found in the cases cited by Finance at trial. See 58 T.C. at 191-192.

In *Bell* the Tax Court points out (¶ 60.52 P-H T.C. 287, 288):

> Here, we are dealing with an annuity which is amply secured, not only by the property transferred, but also by a cognovit judgment that would subject all the property of the transferees to attachment without court proceedings.

Moreover, the corporation—obligors involved in *Bell* were clearly viable corporations with several years of operating history.

In the instant case the obligor on the annuity contracts, Finance, is a newly formed corporation with a total capitalization of $100,000 in cash plus an unsecured promissory note of Rental in the principal sum of $625,000. Yet Finance has obligated itself to pay out $70,000 per year. The Tax Court was compelled to say:

> Unlike the recipient of an ordinary promise to make a payment at a certain time in the future, the Fehrses did not receive anything in 1965 which they could have disposed of even at a substantial discount. 58 T.C. at 191.

We think the *Bell* case is inapposite to the situation which this case presents. Indeed, the more established doctrine of the Tax Court has been that where unsecured private annuities are involved, gain need not be reported in the year of the transfer due to the uncertainty of payment involved. *Bell, supra* at 291 (dissenting opinion); *J. Darsie Lloyd*, 33 BTA 903 (1936); *Commissioner* v. *Kann's Estate*, 174 F.2d 357 (CA3 1949) (affirming an unreported decision of the Tax Court).

For all of the foregoing reasons, the basis of the Rental Company stock held by Finance is (under section 362(a)(2) of the Internal Revenue Code) the same as it was in the hands of Mr. and Mrs. Fehrs—zero.

III.

The final point for consideration on this appeal concerns the argument of the Internal Revenue Service on cross-appeal. IRS attacks that portion of the Tax Court decision modifying the original reported opinion.

Subsequent to the redemption transaction between Finance and Mr. and Mrs. Fehrs the IRS determined that the Fehrs were required to pay gift taxes on the difference between the value of the stock transferred and the value of the annuities. Mr. and Mrs. Fehrs promptly paid the gift tax and filed for refund. See 58 T.C. at 179.

In an unreported memorandum of August 14, 1972, the Tax Court held:

> *** that the petitioner is entitled to an increased basis in the Rental stock by reason of the gift taxes paid, if

such taxes are not refunded before the entry of the decision in this case.

The Court awarded the addition to basis pursuant to 26 USC § 1015(d)(1)(A) which provides in applicable part:

> If—
> (A) the property is acquired by gift * * * the basis shall be the basis * * * increased (but not above the fair market value of the property at the time of the gift) by the amount of gift tax paid with respect to such gift, * * *

IRS contends that the tax has not been "paid" within the meaning of 1015 since the claim for refund is still pending. For that reason IRS contends that the gift tax cannot be added to basis on a 1015 pretext. The Service also declares that since the Tax Court had no evidence upon which it could premise an independent determination that a gift was in fact made it cannot hold that 1015(d) warrants an increase in basis. No authority is offered by IRS for its contention and we have found none.

The Tax Court said in its unreported memorandum:

> There is no indication that the word "paid" in section 1015(d) is to be given anything but its ordinary meaning. In deciding whether a tax was paid within the meaning of other provisions of the tax laws, the courts have examined the facts to find whether the funds transferred to the taxing authority were transferred as security for taxes to be determined in the future or in satisfaction of a tax liability which has already been determined by the taxing authority. *Rosenman* v. *United States*, 323 U.S. 658 (1945); *Ameel* v. *United States*, 426 F.2d 1270 (C.A. 6, 1970); *Estate of Benjamin Piller*, 29 B.T.A. 799 (1934). If the amount transferred was in satisfaction of such a tax liability, the courts have concluded that a payment was made even though the determination of tax liability was being contested by the taxpayer. *Rosenman* v. *United States*, *supra; see Ameel* v. *United States, supra.*

A review of the above decisions cited by the Tax Court satisfies us that the decision here has a reasonable basis in law and is warranted by the record.

The judgment of the Tax Court is affirmed.

JUDGMENT OF COURT OF APPEALS—

JUDGMENT UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

No. 72-1638 Fehrs Finance Company, *Appellant,* vs. Commissioner of Internal Revenue, *Appellee.* No. 73-1068 Fehrs Finance Company, *Appellee,* vs. Commissioner of Internal Revenue, *Appellant.*	September Term, 1973 Appeal from Decision of the United States Tax Court.

These causes came on to be heard on the record from the United States Tax Court, appendix and briefs of the respective parties and were argued by counsel.

On Consideration Whereof, it is now here ordered and adjudged by this Court that the judgment of the said Tax Court in this cause, be, and the same is hereby, affirmed.

November 6, 1973

STATUTES AND REGULATIONS INVOLVED

INTERNAL REVENUE CODE OF 1954

SEC. 302. DISTRIBUTIONS IN REDEMPTION OF STOCK.

(a) GENERAL RULE.—If a corporation redeems its stock (within the meaning of section 317(b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.

(b) REDEMPTIONS TREATED AS EXCHANGES.—

(1) REDEMPTIONS NOT EQUIVALENT TO DIVIDENDS.—Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.

* * *

(3) TERMINATION OF SHAREHOLDER'S INTEREST.—Subsection (a) shall apply if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder.

(c) CONSTRUCTIVE OWNERSHIP OF STOCK.—

* * *

(2) FOR DETERMINING TERMINATION OF INTEREST.—

(A) In the case of a distribution described in subsection (b) (3), section 318 (a) (1) shall not apply if—

(i) immediately after the distribution the distributee has no interest in the corporation (including an interest as officer, director, or employee), other than an interest as a creditor,

(ii) the distributee does not acquire any such interest (other than stock acquired by bequest or inheritance) within 10 years from the date of such distribution, and

(iii) the distributee, at such time and in such manner as the Secretary or his delegate by regulations prescribes, files an agreement to notify the Secretary or his delegate of any

acquisition described in clause (ii) and to retain such records as may be necessary for the application of this paragraph.

If the distributee acquires such an interest in the corporation (other than by bequest or inheritance) within 10 years from the date of the distribution, then the periods of limitation provided in sections 6501 and 6502 on the making of an assessment and the collection by levy or a proceeding in court shall, with respect to any deficiency (including interest and additions to the tax) resulting from such acquisition, include one year immediately following the date on which the distributee (in accordance with regulations prescribed by the Secretary or his delegate) notifies the Secretary or his delegate of such acquisition; and such assessment and collection may be made notwithstanding any provision of law or rule of law which otherwise would prevent such assessment and collection.

(B) Subparagraph (A) of this paragraph shall not apply if—

(i) any portion of the stock redeemed was acquired, directly or indirectly, within the 10-year period ending on the date of the distribution by the distributee from a person the ownership of whose stock would (at the time of distribution) be attributable to the distributee under section 318 (a), or

(ii) any person owns (at the time of the distribution) stock the ownership of which is attributable to the distributee under section 318 (a) and such person acquired any stock in the corporation, directly or indirectly, from the distributee within the 10-year period ending on the date of the distribution, unless such stock so acquired from the distributee is redeemed in the same transaction.

The preceding sentence shall not apply if the acquisition (or, in the case of clause (ii), the disposition) by the distributee did not have as one of its principal purposes the avoidance of Federal income tax.

SEC. 304. REDEMPTION THROUGH USE OF RELATED CORPORATIONS.

(a) TREATMENT OF CERTAIN STOCK PURCHASES.—

(1) ACQUISITION BY RELATED CORPORATION (OTHER THAN SUBSIDIARY).—For purposes of sections 302 and 303, if—

(A) one or more persons are in control of each of two corporations, and

(B) in return for property, one of the corporations acquires stock in the other corporation from the person (or persons) so in control,

then (unless paragraph (2) applies) such property shall be treated as a distribution in redemption of the stock of the corporation acquiring such stock. In any such case, the stock so acquired shall be treated as having been transferred by the person from whom acquired, and as having been received by the corporation acquiring it, as a contribution to the capital of such corporation.

(2) ACQUISITION BY SUBSIDIARY.—For purposes of sections 302 and 303, if—

(A) in return for property, one corporation acquires from a shareholder of another corporation stock in such other corporation, and

(B) the issuing corporation controls the acquiring corporation,

then such property shall be treated as a distribution in redemption of the stock of the issuing corporation.

(b) SPECIAL RULES FOR APPLICATION OF SUBSECTION (a).—

(1) RULE FOR DETERMINATIONS UNDER SECTION 302(b).—In the case of any acquisition of stock to which subsection (a) of this section applies, determinations as to whether the acquisition is, by reason of section 302(b), to be treated as a distribution in part or full payment in exchange for the stock shall be made by reference to the stock of the issuing corporation. In applying section 318(a) (relating to constructive ownership of stock) with respect to section 302(b) for purposes of this paragraph, sections 318(a)(2)(C) and 318(a)(3)(C) shall be applied without regard to the 50 percent limitation contained therein.

(2) AMOUNT CONSTITUTING DIVIDEND.—

(A) WHERE SUBSECTION (a) (1) APPLIES.—In the case of any acquisition of stock to which paragraph (1) (and not paragraph (2)) of subsection (a) of this section applies, the determination of the amount which is a dividend shall be made solely by reference to the earnings and profits of the acquiring corporation.

(B) WHERE SUBSECTION (a) (2) APPLIES.—In the case of any acquisition of stock to which subsection (a)(2) of this section applies, the determination of the amount which is a dividend shall be made as if the property were distributed by the acquiring corporation to the issuing corporation and immediately thereafter distributed by the issuing corporation.

(c) CONTROL.—

(1) IN GENERAL.—For purposes of this section, control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of shares of all classes of stock. If a

person (or persons) is in control (within the meaning of the preceding sentence) of a corporation which in turn owns at least 50 percent of the total combined voting power of all stock entitled to vote of another corporation, or owns at least 50 percent of the total value of the shares of all classes of stock of another corporation, then such person (or persons) shall be treated as in control of such other corporation.

(2) CONSTRUCTIVE OWNERSHIP.—Section 318(a) (relating to the constructive ownership of stock) shall apply for purposes of determining control under paragraph (1). For purposes of the preceding sentence, sections 318(a)(2)(C) and 318(a)(3)(C) shall be applied without regard to the 50 percent limitation contained therein.

SEC. 318. CONSTRUCTIVE OWNERSHIP OF STOCK.

(a) GENERAL RULE.—For purposes of those provisions of this subchapter to which the rules contained in this section are expressly made applicable—

(1) MEMBERS OF FAMILY.—

(A) IN GENERAL.—An individual shall be considered as owning the stock owned, directly or indirectly, by or for—

(i) his spouse (other than a spouse who is legally separated from the individual under a decree of divorce or separate maintenance), and

(ii) his children, grandchildren, and parents.

(B) EFFECT OF ADOPTION.—For purposes of subparagraph (A) (ii), a legally adopted child of an individual shall be treated as a child of such individual by blood.

SEC. 362. BASIS TO CORPORATIONS.

(a) PROPERTY ACQUIRED BY ISSUANCE OF STOCK OR AS PAID-IN SURPLUS.—If property was acquired on or after June 22, 1954, by a corporation—

(1) in connection with a transaction to which section 351 (relating to transfer of property to corporation controlled by transferor) applies, or

(2) as paid-in surplus or as a contribution to capital,

then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer.

(b) TRANSFERS TO CORPORATIONS.—If property was acquired by a corporation in connection with a reorganization to which this part applies, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer. This subsection shall not apply if the property acquired consists of stock or securities in a corporation a party to the reorganization, unless acquired by the exchange of stock or securities of the transferee (or of a corporation which is in control of the transferee) as the consideration in whole or in part for the transfer.

(c) SPECIAL RULE FOR CERTAIN CONTRIBUTIONS TO CAPITAL.—

(1) PROPERTY OTHER THAN MONEY.—Notwithstanding subsection (a)(2), if property other than money—

(A) is acquired by a corporation, on or after June 22, 1954, as a contribution to capital, and

(B) is not contributed by a shareholder as such,

then the basis of such property shall be zero.

(2) MONEY.—Notwithstanding subsection (a)(2), if money—

(A) is received by a corporation, on or after June 22, 1954, as a contribution to capital, and

(B) is not contributed by a shareholder as such,

then the basis of any property acquired with such money during the 12-month period beginning on the day the contribution is received shall be reduced by the amount of such contribution. The excess (if any) of the amount of such contribution over the amount of the reduction under the preceding sentence shall be applied to the reduction (as of the last day of the period specified in the preceding sentence) of the basis of any other property held by the taxpayer. The particular properties to which the reductions required by this paragraph shall be allocated shall be determined under regulations prescribed by the Secretary or his delegate.

§ 1.302-4. Termination of shareholder's interest.

Section 302(b)(3) provides that a distribution in redemption of all of the stock of the corporation owned by a shareholder shall be treated as a distribution in part or full payment in exchange for the stock of such shareholder. In determining whether all of the stock of the shareholder has been redeemed, the general rule of section 302(c)(1) requires that the rules of constructive ownership provided in section 318(a) shall apply. Section 302(c)(2), however, provides that section 318(a)(1) (relating to constructive ownership of stock owned by members of a family) shall not apply where the specific requirements of section 302(c)(2) are met. The following rules shall be applicable in determining whether the specific requirements of section 302(c)(2) are met:

(a) The agreement specified in section 302(c)(2)(A)(iii) shall be in the form of a separate statement in duplicate signed by the distributee and attached to his return timely filed for the year in which the distribution described in section 302(b)(3) occurs. The agreement shall recite that the distributee has not acquired any interest in the corporation (as described in section 302(c)(2)(A)(i)) since such distribution, and that he agrees to notify the district director of internal revenue for the district in which such return is filed of any acquisition of such an interest in the corporation within 30 days after such acquisition if such acquisition occurs within 10 years from the date of such distribution.